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No. 90-

IN THE

Supreme Court of the United States

OCTOBER TERM, 1990

KRAFT GENERAL FOODS, INC.
(formerly KRAFT, INC.),

Petitioner,

v.

IOWA DEPARTMENT OF REVENUE AND FINANCE,

Respondent.

PETITION FOR A WRIT OF CERTIORARI TO THE SUPREME COURT OF IOWA

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QUESTIONS PRESENTED

1. Whether a state statute can be found to discriminate impermissibly against foreign commerce in violation of the Foreign Commerce Clause without a showing that the discrimination provides a commercial advantage to purely local business.

2. Whether the Iowa Business Tax on Corporations, which facially discriminates against foreign commerce by including foreign subsidiary dividends in the Iowa corporate tax base while excluding domestic subsidiary dividends from that base, violates the Foreign Commerce Clause.

3. Whether the Iowa Business Tax on Corporations violates the Equal Protection Clause because its classification of dividend income is not rationally related to a legitimate state purpose.

Rule 29.1 Statement

The parent company of petitioner is Philip Morris Companies Inc. The subsidiaries of petitioner, other than wholly-owned subsidiaries, are listed in the Appendix at pages 76a-79a.

TABLE OF CONTENTS

	Page
QUESTIONS PRESENTED	i
RULE 29.1 STATEMENT	ii
OPINIONS BELOW	1
JURISDICTION	2
CONSTITUTIONAL AND STATUTORY PROVISIONS INVOLVED	2
STATEMENT	2
A. Relevant Facts	2
B. Iowa Taxing Scheme	3
1. Calculation of Federal "Taxable Income"	4
2. Calculation of Iowa "Net Income"	6
C. Similar State Taxing Schemes	6
D. Proceedings Below	7
REASONS FOR GRANTING THE WRIT	9
I. IMPERMISSIBLE DISCRIMINATION AGAINST FOREIGN COMMERCE DOES NOT REQUIRE A SHOWING OF LOCAL BENEFIT.	11
A. The Decision Below Is in Conflict with Decisions of This Court and with Decisions of the Highest Courts of Two Other States.	11
1. The Decision Below Conflicts with Prior Decisions of This Court and the Highest Court of Florida.	13
2. The Analysis of the Court Below Also Squarely Conflicts with the Interpretation of This Court's Prior Decisions by the Highest Court of California.	15

B. The Issue Here Presented Is One of Great Significance to U.S. Multinational Corporations That Carry on Their Unitary Businesses Partly Through Foreign Subsidiaries. 17

II. IOWA'S CLASSIFICATION OF DIVIDEND INCOME DENIES PEITITONER EQUAL PROTECTION BECAUSE IT IS NOT RATIONALLY RELATED TO A LEGITIMATE STATE PURPOSE. 18

A. In Contrast to the Federal Tax Treatment of Subsidiary Dividends, No Legitimate State Purpose Is Served by the Classification Adopted by Iowa. 19

B. Iowa's Taxing Scheme Is Inconsistent with the Contention That Its Discrimination Is Rationally Related to Achieving Taxpayer or Administrative Convenience. 21

CONCLUSION 23

TABLE OF AUTHORITIES

Page

Constitution

Commerce Clause of the United States Constitution, art. I, sec. 8, cl. 3 2

Equal Protection Clause of the United States Constitution, amend. XIV, sec. 1 2

Cases

Allegheny Pittsburgh Coal Co. v. *County Comm'n*, 488 U.S. 336 (1988) 20

ASARCO, Inc., v. *Idaho State Tax Comm'n*, 458 U.S. 307 (1982) 18n.13

Bacchus Imports, Ltd. v. *Dias*, 468 U.S. 263 (1984) 12

Boston Stock Exchange v. *State Tax Comm'n*, 429 U.S. 318 (1977) 15,16

Complete Auto Transit, Inc. v. *Brady*, 430 U.S. 274 (1977) 11

Cook v. *Commonwealth of Pennsylvania*, 97 U.S. 566 (1878) 13,14

Evco v. *Jones*, 409 U.S. 91 (1972) 14

F.W. Woolworth Co. v. *Taxation and Revenue Dept.*, 458 U.S. 354 (1982) 18n.13

Graham v. *Richardson*, 403 U.S. 365 (1971) 19

Hale v. *Bimco Trading, Inc.*, 306 U.S. 375 (1939) 13

J.D. Adams Mfg. Co. v. *Storen*, 304 U.S. 307 (1938) 14

Japan Line, Ltd. v. *County of Los Angeles*, 441 U.S. 434 (1979) 11,12n.9,14

Matthews v. *Diaz*, 426 U.S. 67 (1976) 19

Miller v. *Publicker Industries, Inc.* 457 So. 2d 1374 (Fla. 1984) 14

Table of Authorities Continued

	Page
Mobil Oil Corp. v. *Commissioner of Taxation*, 445 U.S. 425 (1980)	15,17,18&n.12
Shell Oil Co. v. *Iowa Dept. of Revenue*, 488 U.S. 19 (1988)	12n.10
Society For Savings v. *Bowers*, 349 U.S. 143 (1954)	21n.14
Star-Kist Foods, Inc. v. *County of Los Angeles*, 227 Cal. Rptr. 391, 42 Cal. 3d 1, 719 P.2d 987 (1986), *cert. denied*, 480 U.S. 930 (1987)	16
Western & Southern Life Ins. Co. v. *State Bd. of Equalization*, 451 U.S. 648 (1981)	19
Westinghouse Elec. Corp. v. *Tully*, 466 U.S. 388 (1984)	12n.10
Weston v. *Charleston*, 2 Pet 449, 7 L.Ed. 481 (1829)	21n.14
Wheeling Steel Corp. v. *Glander*, 337 U.S. 562 (1949)	18
WHYY, Inc. v. *Borough of Glassboro*, 393 U.S. 117 (1968)	18
Williams v. *Vermont*, 472 U.S. 14 (1985)	18
Zee Toys, Inc. v. *County of Los Angeles*, 85 Cal. App. 3d 763, 149 Cal. Rptr. 750 (1978), *aff'd by an equally divided Court, sub nom. Sears, Roebuck and Co.* v. *County of Los Angeles*, 449 U.S. 1119 (1981)	16

Codes, Statutes and Regulations

26 U.S.C. sec. 243	2,4&n.3
26 U.S.C. sec. 901	2,5
26 U.S.C. sec. 902	2,5
26 U.S.C. sec. 1504	2,4
26 U.S.C. sec. 1504(b)	5n.3
26 U.S.C. sec. 7701	2
26 U.S.C. sec. 7701(a)(4)	4

Table of Authorities Continued

	Page
28 U.S.C. sec. 1257(a)	2
31 U.S.C. sec. 3124 (1988)	21n.14
Iowa Code sec. 422.33 (1983)	2,4n.1
Iowa Code Ann. 422.33 (1990 & Supp. 1991)	3
Iowa Code sec. 422.35 (1983)	2,4n.1,21n.14,22
Iowa Code Ann. 422.35 (1990 & Supp. 1991)	4,22
Treas. Reg. sec. 1.1502-14(a)(1)	2,5n.3

Other Authorities

Bittker and Eustice, *Federal Income Taxation of Corporations and Shareholders*, ¶¶ 5.05 and 17.11 (5th ed. 1987)	5

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OPINIONS BELOW

The opinion of the Supreme Court of Iowa in this case has been reported at 465 N.W.2d 664 (Iowa 1991). The court's opinion is reproduced in the Appendix at pages 1a-10a. The order of the Supreme Court of Iowa denying rehearing is reproduced in the Appendix at page 57a. The findings of fact, conclusions of law, and judgment of the District Court of Iowa in and for Polk County have not been reported. They are reproduced in the Appendix at pages 11a-23a. The order of the Iowa Department of Revenue and Finance has not been reported. It is reproduced in the Appendix at pages 24a-27a.

JURISDICTION

The judgment of the Supreme Court of Iowa was entered on February 20, 1991. Petitioner's timely petition for rehearing was denied on March 19, 1991. (App. 57a). The jurisdiction of this Court is invoked under 28 U.S.C. sec. 1257(a).

CONSTITUTIONAL AND STATUTORY PROVISIONS INVOLVED

The Commerce Clause of the United States Constitution, art. I, sec. 8, cl. 3 provides: The Congress shall have power "[t]o regulate Commerce with foreign Nations, and among the several States, and with the Indian Tribes."

The Equal Protection Clause of the United States Constitution, amend. XIV, sec. 1 provides that: "No state shall . . . deny to any person within its jurisdiction the equal protection of the laws."

Relevant portions of Sections 422.33 and 422.35 of the Iowa Code, Sections 243, 901, 902, 1504, and 7701 of the Internal Revenue Code, and section 1.1502-14(a)(1) of the Federal Income Tax Regulations are set forth in the Appendix at pages 58a-65a, 66a-71a, and 72a, respectively.

STATEMENT

A. Relevant Facts

Petitioner is a Delaware corporation with its commercial domicile in Illinois. It operates a unitary business in Iowa, other states, and certain foreign countries. In 1981, petitioner owned more than 80 percent of the capital stock of six corporations that

were part of its unitary business and that conducted their business activities exclusively outside the United States. (App. 29a). Those subsidiaries (and their respective countries of incorporation) were Dominion Dairies Ltd. (Canada); Kraft Limited (Canada); Kraft Foods S/A (Denmark); Kraft G.m.b.H. (Germany); Kraft S.p.A. (Italy); and Alimentos Kraft de Venezuela C.A. (Venezuela). During 1981, those subsidiaries paid to petitioner aggregate dividends of $10,181,815, less foreign withholding taxes of $1,490,887, out of the profits from their foreign operations. (App. 53a).

For a variety of reasons, U.S. corporations conducting business abroad typically do so through subsidiary corporations organized in the countries in which they operate. The parties have stipulated that those reasons include, but are not limited to, the requirements of the foreign country, a better ability to limit the company's liability in that country, marketing advantages as customers perceive the subsidiary as a local company, greater ease in repatriating funds, greater ease in borrowing funds in the country of operation, and the ability to own property and to manufacture in that country. (App. 30a-31a).

B. Iowa Taxing Scheme

The Iowa Business Tax on Corporations imposes an income tax on that portion of the "net income" of a corporation attributable to its trade or business carried on within Iowa. The amount subject to tax is determined by the application of Iowa's apportionment formula to the corporation's entire unitary "net income." Iowa Code Ann. sec. 422.33 (West 1990 & Supp. 1991). Iowa law uses federal law as its starting point. It defines "net income" as "the taxable income

. . . as properly computed for federal income tax purposes under the Internal Revenue Code . . .", with certain adjustments. Iowa Code Ann. sec. 422.35 (West 1990 & Supp. 1991).[1]

1. Calculation of Federal "Taxable Income"

In determining "taxable income" for federal income tax purposes, the Internal Revenue Code permits a corporation to deduct from its gross income a certain percentage of the dividends it receives from "a domestic corporation which is subject to [federal income] taxation." 26 U.S.C. sec. 243.[2] For this purpose, a "domestic corporation" is defined as a corporation organized in the United States. 26 U.S.C. sec. 7701(a)(4).

If the dividend payor and recipient are members of the same "affiliated group" of corporations, *e.g.*, if the recipient owns at least 80 percent of the capital stock of the payor, a so-called "dividends received deduction" equal to 100 percent of the dividends received is allowed. 26 U.S.C. secs. 243, 1504.[3] Divi-

[1] For the taxable year 1981, the year here in question, the relevant Iowa Code provisions were essentially the same. Iowa Code secs. 422.33, 422.35 (1983).

[2] So far as here pertinent, the same basic provisions appear in both the Internal Revenue Code of 1954 and the Internal Revenue Code of 1986, as amended, and now in force. The term "Internal Revenue Code" as used throughout applies to either Code interchangeably.

[3] If the recipient corporation owns less than 80 percent of the capital stock of the payor corporation, the amount of the dividends received deduction is reduced. In 1981, the deduction in such a case equalled 85 percent of the dividends received. 26 U.S.C. sec. 243. (1976 & Supp. V 1981).

Members of an "affiliated group" of corporations (*i.e.*, those

dends eligible for the full 100 percent "dividends received deduction" are hereinafter referred to as "domestic subsidiary dividends."

In contrast to its treatment of "domestic subsidiary dividends," the Internal Revenue Code does not permit a corporation to deduct any portion of the dividends it receives from foreign subsidiaries that conduct their business operations exclusively in foreign countries. Such dividends are thus fully includible in U.S. taxable income. However, a credit is generally allowed to the recipient of dividends from foreign subsidiaries for related foreign taxes paid. 26 U.S.C. secs. 901, 902. Dividends received from a foreign subsidiary that conducts its business outside the United States, and in which the U.S. parent owns at least 80 percent of the capital stock, will hereinafter be referred to as "foreign subsidiary dividends."

Federal law does not tax domestic subsidiary dividends because they are drawn from income that itself is subject to U.S. tax as earned by the domestic subsidiary. The dividends received deduction thus avoids U.S. double taxation of the same income. Federal law taxes foreign subsidiary dividends because the underlying income earned by the foreign subsidiary is not subject to U.S. tax. The foreign tax credit is allowed to mitigate the consequences of international double taxation. Bittker and Eustice, *Federal Income Taxa-*

linked by at least 80 percent stock ownership) may elect to file a single consolidated federal income tax return. In such a case, dividends paid by a subsidiary to its parent corporation are also fully excluded from taxable income. (Treas. Reg. sec. 1.1502-14(a)(1).) Only domestic corporations are eligible to join in the filing of a consolidated return. (26 U.S.C. sec. 1504(b).)

tion of Corporations and Shareholders, ¶¶ 5.05 and 17.11 (5th ed. 1987).

2. Calculation of Iowa "Net Income"

As noted, Iowa adopts federal "taxable income" as the starting point for determining corporate "net income" that it subjects to apportionment. Accordingly, a corporation doing business in Iowa calculates its Iowa tax base with (1) "domestic subsidiary dividends" fully excluded, by virtue of the federal dividends received deduction, and (2) "foreign subsidiary dividends" fully included, by virtue of the absence of a comparable federal deduction for such dividends. Because Iowa does not adopt all provisions of the Internal Revenue Code, however, the corporation is not allowed a credit against its Iowa tax for related foreign taxes paid with respect to its foreign subsidiary dividends.

As illustrated by Exhibits 4 and 5 to the Stipulation below (App. 55a-56a), Iowa subjects a corporation receiving a $100,000 foreign subsidiary dividend to a greater tax than an otherwise similarly situated corporation receiving a $100,000 domestic subsidiary dividend. Iowa's inclusion of only foreign subsidiary dividends in the corporate tax base thus results in the imposition of a discriminatory income tax on any corporation operating in Iowa whose unitary business includes the activities of subsidiaries organized and operating in foreign countries.

C. Similar State Taxing Schemes

In addition to Iowa, 39 states utilize federal taxable income as the starting point for calculating net income subject to corporate income tax.[4] Nine of those states have adopted the federal tax treatment of foreign and domestic subsidiary dividends.[5] Two of the nine states discriminate in identical fashion with Iowa,[6] and seven do so with certain modifications.[7] Two other jurisdictions that do not follow the federal system discriminate in a manner similar to Iowa.[8]

D. Proceedings Below

In calculating its federal taxable income for 1981, petitioner included its foreign subsidiary dividends in

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[4] Five states with a corporate income tax (Alabama, Arkansas, California, Mississippi, and Utah) plus the District of Columbia do not utilize federal taxable income as the starting point in their calculations. Five other states (Nevada, South Dakota, Texas, Washington, and Wyoming) do not impose a corporate income tax.

See Appendix J for all state statutory citations.

[5] Fifteen of the 39 states have excluded both domestic and foreign subsidiary dividends from their tax base calculation. Arizona, Connecticut, Delaware, Florida, Georgia, Illinois, Indiana, Kentucky, Maryland, Michigan, Nebraska, Ohio, Pennsylvania, Virginia, and West Virginia.

Eleven states have included both in the calculation. Hawaii, Louisiana, Massachusetts, Minnesota, New Jersey, New York, North Carolina, North Dakota, Oregon, Tennessee, and Wisconsin.

Four states (Alaska, Idaho, Montana, and New Hampshire) that utilize federal taxable income have adopted variations on the federal law that make comparisons inappropriate.

[6] New Mexico and Vermont.

[7] Colorado, Kansas, Maine, Missouri, Oklahoma, Rhode Island, and South Carolina. For example, Kansas follows federal law by excluding 100 percent of domestic subsidiary dividends, but it includes 20 percent of foreign subsidiary dividends.

[8] Alabama and the District of Columbia.

accordance with applicable federal rules. (App. 32a). (Petitioner received no domestic subsidiary dividends in that year.) Petitioner also claimed a credit against its federal tax for foreign taxes paid with respect to its foreign subsidiary dividends. *Id.*

In calculating its 1981 "net income" for purposes of the Iowa Business Tax on Corporations, petitioner deducted its foreign subsidiary dividends from the amount of federal taxable income it had separately calculated. The Iowa Department of Revenue and Finance ("the Department") assessed additional tax against petitioner on the ground that the foreign subsidiary dividends should have been included in petitioner's Iowa tax base.

Before the Department, petitioner challenged the constitutionality of the Iowa taxing statute under the Commerce and the Equal Protection Clauses of the United States Constitution and on other grounds. The Iowa Director of Revenue declined to render a decision on the "facial constitutionality" of the statute. (App. 26a).

On review, the District Court of Iowa in and for Polk County ("District Court") held that the statute did not discriminate in violation of the Commerce Clause because it did not benefit "local in-state industry in detriment to out-of-state industry." (App. 16a-17a). The District Court also held that the tax did not result in multiple taxation in violation of the Commerce Clause, and that the statute did not violate the Equal Protection Clause.

The Supreme Court of Iowa affirmed. It held that the statute did not violate the Commerce Clause because it did not benefit Iowa businesses at the expense of foreign businesses (App. 7a-8a), and that the Equal Protection Clause was not violated because the State's purpose in using federal taxable income as the starting point for computing its tax base—taxpayer and administrative convenience—was a legitimate state purpose. (App. 23a).

The parties have stipulated that the total amount of tax assessed against petitioner by Iowa for 1981 was approximately $39,000 (App. 33a), approximately $17,000 of which was attributable to the issue here presented. The outcome of this case will affect taxable years of petitioner from 1978 forward. (App. 43a).

REASONS FOR GRANTING THE WRIT

The instant case squarely presents one of the most fundamental constitutional issues arising under the Foreign Commerce Clause—whether a state statute can be found to discriminate impermissibly against foreign commerce without a showing that the discrimination provides a commercial advantage to purely local business. Stated another way, the fundamental question to be resolved is whether a state taxing scheme that facially discriminates against foreign commerce must be shown to favor *intrastate commerce*, rather than *domestic commerce* generally, in order to be held unconstitutional.

The Iowa courts concluded that a showing of discrimination in favor of *intrastate commerce* was required before a state tax on foreign commerce could be considered unconstitutional under the Foreign Commerce Clause. The court below, although acknowledging that "Supreme Court decisions are unclear whether such a local bias must be found when discrimination against foreign commerce is alleged"

(App. 7a), based its holding entirely on a reading of this Court's decisions involving discrimination against *interstate commerce*. At no time has this Court ever suggested, let alone held, that a discriminatory state tax imposed on *foreign commerce* must be shown to produce a commercial advantage to purely local business before it can be declared invalid. Indeed, prior decisions of this Court strongly suggest a contrary conclusion.

The fundamental constitutional issue here presented is raised in the context of a question of considerable importance that this Court has yet to resolve—whether the Foreign Commerce Clause permits a state to discriminate by including foreign subsidiary dividends in its corporate tax base while excluding domestic subsidiary dividends from that base. Resolution of this question will affect all U.S. multinational corporations that conduct their unitary businesses both in Iowa (or any of the other jurisdictions with discriminatory taxing schemes) and in foreign countries, and that depend on foreign subsidiary dividends as an important source of capital. Discriminatory state taxation of such dividends inevitably places such corporations at a commercial disadvantage relative to those of their competitors whose unitary businesses rely on dividends from domestic subsidiaries.

There is clear disagreement and confusion at the state level regarding the proper test to be applied in determining impermissible discrimination under the Foreign Commerce Clause. Given the substantial number of states that continue to discriminate against foreign subsidiary dividends, guidance from this Court as to the meaning of the "nondiscrimination" requirement under the Foreign Commerce Clause is not only warranted, but absolutely necessary.

This Court should also review the instant case to establish that the disparate treatment of subsidiary dividends adopted by the Iowa legislature is not rationally related to a legitimate state purpose. Extensive reliance on federal tax definitions that do not further any substantive state tax policy can easily give rise to arbitrary distinctions at the state level. The classification of dividend income adopted by Iowa (and the other jurisdictions with similar taxing schemes) is one such example. This Court should make it clear that a mere assertion of "taxpayer and administrative convenience" is not sufficient to validate an arbitrary tax classification under the Equal Protection Clause.

I. IMPERMISSIBLE DISCRIMINATION AGAINST FOREIGN COMMERCE DOES NOT REQUIRE A SHOWING OF LOCAL BENEFIT.

A. The Decision Below Is in Conflict with Decisions of This Court and with Decisions of the Highest Courts of Two Other States.

In *Japan Line, Ltd.* v. *County of Los Angeles*, 441 U.S. 434 (1979), this Court stated that the determination whether a particular tax imposes an impermissible burden on "foreign commerce" is to be made in part by reference to the four tests enumerated in *Complete Auto Transit, Inc.* v. *Brady*, 430 U.S. 274 (1977). Those four tests, which were originally said to be applicable to determinations involving "interstate commerce," are substantial nexus, fair appor-

tionment, nondiscrimination, and a fair relationship to the services provided by the taxing State.[9]

The instant case focuses on the meaning of the "nondiscrimination" requirement as applied under the Foreign Commerce Clause.[10] The Iowa Supreme Court concluded that under existing precedent such as *Bacchus Imports, Ltd.* v. *Dias*, 468 U.S. 263 (1984), which involved discrimination against "interstate commerce," a party claiming that a state taxing scheme impermissibly discriminates in violation of the Commerce Clause is required to show that the alleged discrimination produces a commercial advantage to local business. As the court below stated:

> In the commerce-clause challenge here, we hold that Kraft must show, *as in the case of alleged interstate discrimination*, that Iowa businesses received a commercial advantage over foreign commerce due to Iowa's taxing scheme.

(App. 7a) (emphasis supplied). As will be shown, the Iowa court's analysis is fundamentally unsound.

[9] *Japan Line* went on to declare that because of the "more extensive constitutional inquiry" called for in cases involving the Foreign Commerce Clause, two additional considerations were also to be taken into account—the enhanced risk of multiple taxation, and the possible need for federal uniformity of treatment. *Japan Line*, 441 U.S. at 446-451.

[10] Although the instant case involves discrimination in the composition of the tax base, rather than discriminatory taxation *per se*, that distinction cannot be constitutionally significant. A state discriminates against foreign commerce whether it taxes such commerce at a higher rate than domestic commerce or includes in its tax base certain types of income when generated in foreign commerce but not when generated in domestic commerce. *Cf. Westinghouse Elec. Corp.* v. *Tully*, 466 U.S. 388, 404-405 (1984).

Nothing in *Shell Oil Co.* v. *Iowa Dept. of Revenue*, 488 U.S. 19 (1988), is inconsistent with this conclusion. *Shell* involved questions of extraterritoriality, not discrimination, in the composition of the Iowa tax base.

1. The Decision Below Conflicts with Prior Decisions of This Court and the Highest Court of Florida.

No decision of this Court has ever held that a finding of local commercial advantage is required in order to invalidate a discriminatory tax burden imposed on foreign commerce. The court below either disregarded or misinterpreted those prior decisions of this Court that involved facially discriminatory statutes aimed specifically at foreign commerce, and chose instead to rely on cases involving discrimination against interstate commerce.

This Court established over a century ago that the Framers did not intend to permit a state to single out foreign commercial activity for taxation with virtual impunity, provided only that the state not benefit purely local interests. In *Cook* v. *Commonwealth of Pennsylvania*, 97 U.S. 566 (1878), a decision the court below refused even to acknowledge, this Court struck down as violative of the Foreign Commerce Clause a Pennsylvania tax that was imposed on foreign goods sold at auction, but that specifically exempted "groceries, goods, wares and merchandise of American growth or manufacture." *Id.* at 569. No showing of a local benefit or advantage inuring to items produced in Pennsylvania was required to establish the invalidity of the tax.

Similarly, in *Hale* v. *Bimco Trading, Inc.*, 306 U.S. 375 (1939), this Court considered the validity of a Florida statute that required the inspection of, and

the payment of an inspection fee with respect to, cement imported into Florida from any foreign country. While the legislative history of the statute suggested a desire to benefit the Florida cement industry, the statute imposed no inspection requirements on cement delivered into Florida from other parts of the United States. It thus benefitted all domestic cement producers to the detriment of foreign producers. This Court held that the statute impermissibly discriminated against foreign commerce.

Finally, in discussing concerns of multiple taxation under the Foreign Commerce Clause, this Court in *Japan Line* declared that a state tax "may subject foreign commerce 'to the risk of a double tax burden to which [domestic] commerce is not exposed, and which the commerce clause forbids.' " *Japan Line*, 441 U.S. at 448 (brackets in original), quoting from *Evco* v. *Jones*, 409 U.S. 91, 94 (1972), which in turn quoted from *J.D. Adams Mfg. Co.* v. *Storen*, 304 U.S. 307, 331 (1938), both of which involved "interstate commerce" issues.

By replacing the original word "intrastate," as used in *J.D. Adams Mfg. Co.*, with the bracketed word "[domestic]," this Court in *Japan Line* indicated rather clearly that the Foreign Commerce Clause compares the effect of a statute on foreign commerce with its effect on domestic commerce generally, not with its effect solely on intrastate or purely local commerce. The decision below is totally inconsistent with that position.

The Iowa Supreme Court's decision is also in direct conflict with the holding of the Florida Supreme Court in *Miller* v. *Publicker Industries, Inc.* 457 So. 2d 1374 (Fla. 1984). That case, which like *Cook* v. *Pennsylvania*, *supra*, was completely ignored below, involved the validity of a Florida fuel tax exemption granted only to gasohol containing ethyl alcohol "distilled from U.S. agricultural products or byproducts." The Florida Supreme Court held that the tax exemption violated the Foreign Commerce Clause because it facially discriminated against foreign commerce in ethyl alcohol. No showing was made or required that the tax favored only ethyl alcohol produced in Florida. It was enough that the tax discriminated against foreign produced ethyl alcohol to the benefit of domestically produced ethyl alcohol.

Here, by contrast, the court below refused to strike down the Iowa taxing scheme as applied to foreign subsidiary dividends, even though that scheme clearly favors corporations that conduct their unitary business operations through domestic subsidiaries. The repatriation of foreign subsidiary dividends into the U.S. is as much a part of foreign commerce as is the importation of ethyl alcohol produced abroad. (See *Mobil Oil Corp.* v. *Commissioner of Taxation*, 445 U.S. 425, 446-449 (1980).) Subjecting either item to tax while exempting its domestic counterpart must be equally unconstitutional under the Foreign Commerce Clause.

2. The Analysis of the Court Below Also Squarely Conflicts with the Interpretation of This Court's Prior Decisions by the Highest Court of California.

A second reason why the conclusion of the Iowa Supreme Court is erroneous is that a finding of local commercial advantage is not in fact the *sine qua non* for every determination of impermissible discrimination, even against "interstate commerce." In *Boston Stock Exchange* v. *State Tax Comm'n*, 429 U.S. 318,

335 (1977), this Court declared that a state tax that "discriminates between two types of interstate transactions in order to favor local commercial interests over out-of-state businesses" violates the Commerce Clause. *Boston Stock Exchange* struck down a New York tax on stock transfers that discriminated against sales made by residents and nonresidents outside New York in favor of sales made by nonresidents in New York. While New York's local stock transfer agents, who registered changes in stock ownership, were expected to benefit from an increase in sales made on the New York Stock Exchange, the tax by its terms did not directly advantage that local activity.

In contrast to the approach of the court below, the Supreme Court of California relied on *Boston Stock Exchange* to conclude that the Commerce Clause prohibits "discriminatory tax burdens which favor one class of commerce, subject to the control of Congress, over another such class . . . ." *Zee Toys, Inc.* v. *County of Los Angeles*, 85 Cal. App. 3d 763, 775, 149 Cal. Rptr. 750, 758 (1978), *aff'd by an equally divided Court, sub nom. Sears, Roebuck and Co.* v. *County of Los Angeles*, 449 U.S. 1119 (1981).

In *Zee Toys*, the California court held that a state ad valorem tax that discriminated against interstate commerce *in favor of foreign commerce* violated the Commerce Clause. That holding was reaffirmed in *Star-Kist Foods, Inc.* v. *County of Los Angeles*, 227 Cal. Rptr. 391, 42 Cal. 3d 1, 719 P.2d 987 (1986), *cert. denied*, 480 U.S. 930 (1987). In California, therefore, discrimination in favor of local business is *not* essential to the invalidation of a state statute under the Interstate Commerce Clause. The reasoning of the

court below squarely conflicts with the position of the California Supreme Court on this point.

B. The Issue Here Presented Is One of Great Significance to U.S. Multinational Corporations That Carry on Their Unitary Businesses Partly Through Foreign Subsidiaries.

Iowa is one of three states specifically requiring that the calculation of its corporate tax base be made in strict accordance with federal law insofar as the treatment of subsidiary dividends is concerned. Another nine jurisdictions discriminate against foreign subsidiary dividends in a similar manner.[11]

The issue here presented thus extends far beyond the boundaries of the State of Iowa. Resolution of this issue will affect a substantial number of U.S. corporations that conduct their business operations partly through foreign subsidiaries and that compete in states such as Iowa with corporations that rely on dividends received from domestic subsidiaries.

While this Court previously considered the question of state taxing power over foreign subsidiary dividends in *Mobil*, *supra*, it did not address the precise issue here presented. The issues in *Mobil* were whether Vermont's tax on dividends paid by both domestic and foreign subsidiaries engaged in overseas operations violated the Due Process Clause (lack of substantial nexus) or the Commerce Clause (burden on interstate commerce by virtue of the fact that tax could also be imposed by state of commercial domicile; burden on foreign commerce by virtue of risk of multiple taxation). Mobil specifically chose not to raise

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[11] See discussion at pages 6-7, *supra*.

the "discrimination" issue, even though the Vermont statute was essentially identical to the Iowa statute here involved.[12] There is thus nothing in the *Mobil* opinion that addresses the question raised by the instant case.[13]

The issue here presented is one of fundamental constitutional significance, and is of national importance. By misapplying basic constitutional principles, the court below placed itself in direct conflict with prior decisions of this Court and the highest courts of two other states. This Court should therefore grant the writ to reaffirm its prior holdings on the meaning of the Foreign Commerce Clause, and to establish the full scope of the "nondiscrimination" requirement as applied to the taxation of foreign commerce.

II. IOWA'S CLASSIFICATION OF DIVIDEND INCOME DENIES PETITIONER EQUAL PROTECTION BECAUSE IT IS NOT RATIONALLY RELATED TO A LEGITIMATE STATE PURPOSE.

This Court has not hesitated to invoke the Equal Protection Clause to reject attempts by a state to tax one class of taxpayers on a more onerous basis than another similarly situated class. *Williams* v. *Vermont*, 472 U.S. 14 (1985); *WHYY, Inc.* v. *Borough of Glassboro*, 393 U.S. 117 (1968); *Wheeling Steel Corp.* v. *Glander*, 337 U.S. 562 (1949). Iowa's discriminatory classification can only survive an equal protection challenge if it is "rationally related to achievement of a legitimate state purpose. . . ." *Western & Southern Life Ins. Co.* v. *State Bd. of Equalization*, 451 U.S. 648, 668 (1981).

A. In Contrast to the Federal Tax Treatment of Subsidiary Dividends, No Legitimate State Purpose Is Served by the Classification Adopted by Iowa.

As previously discussed, federal law does not tax domestic subsidiary dividends because it would result in U.S. double taxation of corporate income. Federal law taxes foreign subsidiary dividends because the underlying income of foreign subsidiaries is not itself subject to U.S. tax. (Federal law allows a foreign tax credit to mitigate international double taxation.)

As noted, Iowa adheres strictly to the federal tax treatment of dividend income for purposes of calculating its corporate tax base. However, action that is legitimate when taken at the federal level may become illegitimate when undertaken by a state. *Compare Matthews* v. *Diaz*, 426 U.S. 67 (1976) (alienage distinction in *federal* Medicare law does not violate equal protection) *with Graham* v. *Richardson*, 403 U.S. 365 (1971) (alien exclusion in *state* welfare law violates equal protection).

Iowa cannot avail itself of the federal government's legitimate purpose for excluding domestic subsidiary dividends while taxing foreign subsidiary dividends. Iowa excludes domestic subsidiary dividends even where the income from which they are drawn is not subject to Iowa tax, and offers no credit for foreign taxes paid with respect to foreign subsidiary dividends. Iowa's focus is thus not on double taxation at

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[12] Mobil's decision not to raise the discrimination issue was apparently part of its overall "litigation strategy." (See 445 U.S. at 434).

[13] Two other cases dealing with the taxation of foreign dividends, *ASARCO, Inc.*, v. *Idaho State Tax Comm'n*, 458 U.S. 307 (1982), and *F.W. Woolworth Co.* v. *Taxation and Revenue Dept.*, 458 U.S. 354 (1982), addressed only the Due Process question whether the dividend-paying foreign subsidiaries there involved were part of the unitary businesses of the taxpayers.

all, and its distinction between classes of dividends is completely lacking in substantive tax policy justification.

In recognition of this fact, the Iowa Supreme Court enumerated five purposes purportedly served by the State's differentiation in the treatment of subsidiary dividends. According to the court:

> [T]he coupling of Iowa net income with the federal formula is convenient for the taxpayer, prevents the taxpayer from spending time and money on complex forms, provides a saving to the state, allows the state to rely on federal regulation and interpretation, and provides the state with an inexpensive and quick way of verifying the accuracy of taxpayers returns.

(App. 10a).

"Taxpayer and administrative convenience" cannot be the measure of constitutionality, however, because a state can always claim convenience to justify the imposition of unequal burdens on similarly situated taxpayers. *Cf. Allegheny Pittsburgh Coal Co.* v. *County Comm'n*, 488 U.S. 336, 343 (1988) (equal protection violation found where tax assessments for comparable property were dramatically different because assessor claimed accurate property valuations were only readily available for recently purchased property).

For example, it may be convenient for Iowa to tax Illinois corporations doing business in Iowa based solely on their net income as calculated for Illinois tax purposes: such corporations would not have to spend time and money filling out multiple forms, and the two states could reduce the cost of administering

their tax systems and verifying the accuracy of tax returns by combining their audit efforts. But surely such separate treatment of Illinois corporations vis-a-vis all other corporations doing business in Iowa would not be deemed to satisfy equal protection requirements merely because of the taxpayer and administrative convenience it would afford.[14]

In short, Iowa has no legitimate purpose for taxing corporations receiving foreign subsidiary dividends more onerously than those receiving domestic subsidiary dividends.

B. Iowa's Taxing Scheme Is Inconsistent with the Contention That Its Discrimination Is Rationally Related to Achieving Taxpayer or Administrative Convenience.

Even if the goal of taxpayer and administrative convenience were a legitimate one in this context, Iowa's extensive modifications to the definition of federal taxable income in determining "net income" subject to apportionment undermine its claim that reliance on the federal calculation is in fact "convenient."

For the year 1981, Iowa's taxing statute required corporate taxpayers to make nine separate adjust-

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[14] Iowa itself has recognized that administrative convenience *per se* cannot override other constitutional limitations. In calculating "net income" for Iowa purposes, Iowa taxpayers are required to adjust their federal taxable income by, among other adjustments, subtracting out interest and dividends from federal securities. Iowa Code sec. §422.35 (1983). Iowa thus observes the doctrine of intergovernmental immunity, founded upon the "Borrowing" and "Supremacy" clauses, *Weston* v. *Charleston*, 2 Pet 449, 7 L.Ed. 481 (1829); *Society For Savings* v. *Bowers*, 349 U.S. 143, 144 (1954), and codified by Congress, 31 U.S.C. sec. 3124 (1988), which limits a state's power to tax income from federal securities.

ments to their federal taxable income in order to determine their proper Iowa tax base. Those adjustments consisted of the following: (1) subtract interest and dividends from federal securities; (2) add other interest and dividends exempt from federal tax; (3) adjust the basis used on the federal return for determining gain or loss on the sale of certain assets; (4) subtract 50 percent of net federal income taxes paid; (5) add certain amounts relating to depreciable assets shown on the federal return; (6) subtract targeted job credits granted on the federal return; (7) subtract certain alcohol fuel credits allowed on the federal return; (8) add certain amounts deducted on the federal return for sale-leaseback agreements; and (9) add the windfall profits tax determined on the federal return. Iowa Code sec. 422.35. (1983). (Iowa now requires thirteen adjustments to federal taxable income. Iowa Code Ann. sec. 422.35 (West 1990 & Supp. 1991).)

The varied and complex adjustments required by Iowa undoubtedly cause taxpayers to spend additional time and money in tax preparation. They also undoubtedly require the state to incur particular costs in the administration of its system to verify the adjustments made. It is thus highly doubtful that Iowa's reliance on federal taxable income as the starting point for its tax base calculations serves the purposes articulated by the court below. Reliance on federal taxable income cannot fairly be said to rationally support the goal of taxpayer and administrative convenience if a multiplicity of separate calculations are also required by the state.

Yet, unless this Court reviews the instant case, states like Iowa will continue to believe that, however

arbitrary their tax classifications may be, a mere assertion of "taxpayer and administrative convenience" is all that is required to satisfy the standards of the Equal Protection Clause.

CONCLUSION

For all of the foregoing reasons, the petition for a writ of certiorari should be granted.

Respectfully submitted,

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June 14, 1991

APPENDIX

APPENDIX A

IN THE SUPREME COURT OF IOWA

No. 294/89-1528

Filed February 20, 1991

KRAFT, INC.,

Appellant,

vs.

IOWA DEPARTMENT OF REVENUE AND FINANCE,

Appellee.

Appeal from the Iowa District Court for Polk County, Theodore H. Miller, Judge.

Corporation appeals from judicial review of agency decision subjecting dividends received from foreign subsidiaries to Iowa income tax. AFFIRMED.

John V. Donnelly and Harold N. Schneebeck of Brown, Winick, Graves, Donnelly, Baskerville & Schoenebaum, Des Moines, for appellant.

Thomas J. Miller, Attorney General, Harry M. Griger, Special Assistant Attorney General, and Marcia Mason, Assistant Attorney General, for appellee.

Considered by McGiverin, C.J., and Larson, Schultz, Snell, and Andreasen, JJ.

LARSON, J.

Kraft, Inc., a corporation subject to Iowa income tax, receives dividends from subsidiaries in foreign countries. Under Iowa's income tax statutes, these dividends are required to be included in Kraft's net income, even though dividends from domestic subsidiaries are not. Kraft complains that this violates the commerce clause of the United

States Constitution and denies it equal protection under both the United States and Iowa Constitutions. The district court rejected these arguments, and so do we.

In 1981, the year in question, Kraft received substantial dividends from these subsidiaries from which the foreign countries had withheld their respective taxes. Also, the foreign subsidiaries themselves were taxed by the foreign countries on the earnings from which the dividends had been paid.

Sections 241 and 243 of the Internal Revenue Code, 26 U.S.C., allow taxpayer to deduct from its net income all dividends received from *domestic* subsidiaries. The reason is said to be that all of the domestic corporations' earnings have already been subjected to federal income tax. *United States v. Georgia R.R. & Banking Co.*, 348 F.2d 278, 283 (5th Cir. 1965), *cert. denied*, 382 U.S. 973 (1966). Through Iowa Code section 422.35, which adopts the federal definition of net income, the dividends from a domestic subsidiary are likewise excluded from the Iowa income tax base. Dividends received from *foreign* subsidiaries, however, may not be deducted for federal income tax purposes, although the taxpayer is allowed to claim a *credit* against its federal income tax for the foreign taxes paid.

Iowa does not allow a credit for taxes paid to foreign countries, and therein lies the problem in this case: By adopting the federal formula for computing net income, Iowa allows a deduction for dividends received from domestic corporations, but it does not allow a deduction or tax credit for those received from foreign subsidiaries. Kraft contends that this is unlawful discrimination.

Iowa income tax is imposed upon the portion of a taxpayer's "net income" attributable to its trade or business within Iowa. Iowa Code § 422.33.[1] Section 422.35 defines "net income" as "the taxable income before the net operating loss deduction, as properly computed for federal income tax purposes under the Internal Revenue Code of 1954 . . . .[2]

[1] Unless otherwise specified, all references will be to the 1981 Code.

Under the Iowa taxing system, businesses with multistate or multinational operations pay Iowa income tax on an apportioned basis. Under this method, the business divides its net income between Iowa and the other states or nations in which it does business. The taxpayer multiplies its total net income by a fraction, the numerator of which is the amount of Iowa-based income and the denominator of which is the total income earned by the taxpayer. Iowa Code §§ 422.33(1)(b); 701 Iowa Admin. Code 54.2. The resulting figure is the measure of the tax to be imposed as a result of the taxpayer's Iowa activities. *See Kelly-Springfield Tire Co. v. Iowa State Bd. of Tax Review*, 414 N.W.2d 113, 119 (Iowa 1987).

Kraft argues that the effect of including the foreign dividends in the denominator of this fraction is to tax those dividends; however, this is not actually correct. As the Supreme Court has noted,

> income that is included in the preapportionment tax base is not, by virtue of that inclusion, taxed by the State. Only the fraction of total income that the apportionment formula determines (by multiplying the income tax base by the apportionment fraction) to be attributable to Iowa's taxing jurisdiction is taxed by Iowa.

Shell Oil Co. v. Iowa Dep't of Revenue, 488 U.S. 19, 30, 109 S.Ct. 278, ___, 102 L. Ed. 2d 186, 199 (1988).

In its 1981 federal income tax return, Kraft included the foreign dividends in its tax base, as required, and claimed a foreign tax credit against its federal income tax. In com-

[2] Section 422.35 also allows certain adjustments, none of which are relevant to this case.

puting its Iowa tax base for 1981, however, Kraft deducted the foreign subsidiary dividends from its Iowa net income. It concedes this violates the Iowa tax statutes. The question is whether those statutes are constitutionally valid.

I. The Commerce Clause Argument.

The United States Constitution gives Congress the power "[t]o regulate Commerce with foreign Nations, and among the several States, and with the Indian Tribes . . . ." Art. I, § 8, clause 3. The commerce clause not only confers power on the federal government to regulate commerce but also limits state power to interfere with it. *Lewis v. BT Inv. Managers, Inc.*, 447 U.S. 27, 35, 100 S. Ct. 2009, 2015, 64 L. Ed. 2d 702, 711 (1980). This limitation on state power is often referred to as the "negative implication" of the commerce clause. *New Energy Co. v. Limbach*, 486 U.S. 269, 273, 108 S. Ct. 1803, ___, 100 L. Ed. 2d 302, 308 (1988); L. Tribe, *American Constitutional Law* § 6-2, at 403 (2d ed. 1988).

The Supreme Court has articulated a four-part test to determine whether a state tax violates the commerce clause. A tax is valid under a commerce clause challenge

> when the tax is applied to an activity with a substantial nexus with the taxing State, is fairly apportioned, *does not discriminate against interstate commerce*, and is fairly related to the services provided by the State.

Complete Auto Transit, Inc. v. Brady, 430 U.S. 274, 279, 97 S. Ct. 1076, ___, 51 L. Ed. 2d 326, 331 (1977) (emphasis added). When the challenged state tax affects commerce *outside* the United States, as here, "a more extensive constitutional inquiry is required." *Japan Line, Ltd. v. County of Los Angeles*, 441 U.S. 434, 446, 99 S. Ct. 1813 ___, 60 L. Ed. 2d 336, 346 (1979). When foreign commerce is involved, two additional inquiries must be made:

> [F]irst, whether the tax . . . creates a substantial risk of international multiple taxation, and, second, whether the tax prevents the Federal Government from "speaking with one voice when regulating commercial relations with foreign governments."

Id. at 451, 99 S. Ct. at ___, 60 L. Ed. 2d at 349. If a state tax contravenes either of these precepts, it is unconstitutional. *Id.* Kraft does not ask us to apply this test which is specifically applicable to foreign commerce; rather, it confines its argument to the third prong of *Complete Auto Transit*, claiming that Iowa's tax system unconstitutionally discriminates against foreign commerce.

State statutes are presumed to be constitutional. *Iowa Auto. Dealers v. State Appeal Bd.*, 420 N.W.2d 460, 462 (Iowa 1988). In addition, "[a]ll presumptions are in favor of the constitutionality of the statute and it will not be held invalid unless it is clear, plain and palpable that such decision is required." *City of Waterloo v. Selden*, 251 N.W.2d 506, 508 (Iowa 1977). *Accord Harden v. State*, 434 N.W.2d 881, 885 (Iowa), *cert. denied*, ___ U.S. ___ (1989). This presumption in favor of constitutionality is especially strong where the statute was enacted to promote a public purpose and relates to taxation. *Lee Enters., Inc. v. Iowa State Tax Comm'n*, 162 N.W.2d 730, 739 (Iowa 1968).

The department of revenue argues that the Iowa tax structure does not unconstitutionally discriminate because it does not advantage any local Iowa activity at the expense of non-Iowa activities. According to the department, unlawful discrimination does not exist under the commerce clause unless the statute provides a direct commercial advantage to local business. *See Bacchus Imports, Ltd. v. Dias*, 468 U.S. 263, 268, 104 S. Ct. 3049, ___, 82 L. Ed. 2d 200, 207 (1984); P. Hartman, *Federal Limitations in State and Local Taxation* § ___, at 20 (Supp. 1985) ("A tax is generally said by the Court to be discriminatory

when the taxing State provides a commercial advantage to local business at the expense of out-of-state business.").

Kraft agrees that, in the interstate context, the cases could be read to support the department's argument that some advantage to local business must be shown. It argues, however, that the rules are different in the case of *foreign* commerce. Kraft relies in part on *Hale v. Bimco Trading, Inc.*, 306 U.S. 375, 59 S. Ct. 526, 83 L. Ed. 771 (1939). In *Hale*, the Supreme Court invalidated a Florida statute which provided for the inspection of all imported cement and the payment of a fee for such inspection. The inspection and fee applied to cement brought into Florida from a foreign country, but not to domestic cement. The statute's preamble provided two justifications for the inspection of foreign cement and its attendant fees: first, public safety required that the cement sold in Florida must meet minimum standards, and second, the imported cement created unfair competition to Florida's cement industry.

The Supreme Court pointed out the defects in the public safety rationale: "That no Florida cement needs any inspection while all foreign cement requires inspection at a cost of fifteen cents per hundredweight is too violent an assumption to justify the discrimination here disclosed." *Id.* at 380, 59 S. Ct. at ___, 83 L. Ed. at 776. It noted, as to the second justification, that it was "a candid admission that the very purpose of the statute is to keep out foreign goods." *Id.* Thus, in *Hale*, the Florida statute gave Florida's cement industry a distinct, and unconstitutional, advantage over foreign commerce.

Kraft also relies on *Japan Line, Ltd.* to support its discrimination argument. In *Japan Line, Ltd.*, California's *ad valorem* property tax on Japanese-owned shipping containers was held to violate the commerce clause because it resulted in possible multiple taxation, thereby preventing the United States from "speaking with one voice" in regulating foreign affairs. *Id.* at 452, 99 S.Ct. at ___, 60 L. Ed. 2d at 350. *Japan Line, Ltd.* did not involve discrimination against foreign commerce, which is the basis of Kraft's commerce clause argument.

Although Supreme Court decisions are unclear whether such a local bias must be found when discrimination against foreign commerce is alleged, the authors of one article have stated:

> Arguably, disparity between interstate and foreign commerce is not the evil that the commerce clause generally is supposed to prevent. The commerce clause may be viewed as a protection from local biases against either interstate or foreign commerce. Thus, it can be concluded that not only negative effects on protected commerce, but also positive effects on local commerce are necessary to find a statute unconstitutional under the commerce clause.

Tatarowicz & Mims-Velarde, *An Analytical Approach to State Tax Discrimination Under the Commerce Clause*, 39 Vand. L. Rev. 879, 941 (1986). In the commerce-clause challenge here, we hold that Kraft must show, as in the case of alleged interstate discrimination, that Iowa businesses receive a commercial advantage over foreign commerce due to Iowa's taxing scheme.

Kraft alleges that local Iowa businesses are advantaged because taxpayers which receive dividends from domestic subsidiaries are benefited in the form of a lower Iowa income tax than if dividends from both foreign and domestic subsidiaries were taxed alike. We do not subscribe to this argument; this "benefit" is not created at the disadvantage of out-of-state businesses. Kraft is incorrect in comparing Iowa businesses to each other; the question is whether Iowa businesses are benefited at the expense of foreign businesses. Because the Iowa tax does not differentiate between in-state or out-of-state taxpayers, no im-

permissible discrimination exists. This case is therefore factually distinguishable from *Hale*.

II. The Equal Protection Argument.

Our court has recognized that Iowa Constitution, article 1, section 6 places substantially the same limitation on state legislation as does the equal protection clause of the fourteenth amendment. *See Hearst Corp. v. Iowa Dep't of Revenue & Fin.*, 461 N.W.2d 295, 304 (Iowa 1990); *Klein v. Department of Revenue & Fin.*, 451 N.W.2d 837, 842 (Iowa 1990); *Harden*, 434 N.W.2d at 885. Consequently, Kraft's challenges to the tax statutes under the United States and Iowa Constitutions will be addressed simultaneously.

A party challenging a statute under the equal protection clause has a heavy burden. *Bennett v. City of Redfield*, 446 N.W.2d 467, 474 (Iowa 1989); *Iowa S. Utils. Co. v. Iowa State Commerce Comm'n*, 372 N.W.2d 274, 279 (Iowa 1985); *Stracke v. City of Council Bluffs*, 341 N.W.2d 731, 734 (Iowa 1983). Kraft has

> the burden to demonstrate beyond a reasonable doubt the act violates the [equal protection clause] and to point out with particularity the details of the alleged invalidity. To sustain this burden [*Kraft*] *must negative every reasonable basis which may support the statute.* Every reasonable doubt is resolved in favor of constitutionality.

Selden, 251 N.W.2d at 508 (citations omitted) (emphasis added).

We have applied the Supreme Court's "standard of rationality" in evaluating state economic regulations. *Hearst Corp.*, 461 N.W. 2d at 304-06; *Bennett*, 446 N.W.2d at 474. In *Selden*, 251 N.W.2d at 509, we quoted *City of New Orleans v. Dukes*, 427 U.S. 297, 303-04, 96 S. Ct. 2513, ___, 49 L. Ed. 2d 511, 516-17 (1976):

> When local economic regulation is challenged solely as violating the Equal Protection Clause,

> this Court consistently defers to legislative determinations as to the desirability of particular statutory discriminations. Unless a classification trammels fundamental personal rights or is drawn upon inherently suspect distinctions such as race, religion, or alienage, our decisions presume the constitutionality of the statutory discriminations and *require only that the classification challenged be rationally related to a legitimate state interest* . . . . [I]n the local economic sphere, it is only the invidious discrimination, the wholly arbitrary act, which cannot stand consistently with the Fourteenth Amendment.

(Citations omitted) (emphasis added). Since no suspect classification or fundamental right is claimed in this case,[3] Iowa's taxing statute survives Kraft's equal protection challenge unless it is wholly arbitrary, having no rational relation to any legitimate state purpose. *See Hearst Corp.*, 461 N.W.2d at 305; *Klein*, 451 N.W.2d at 842; *Bennett*, 446 N.W.2d at 474; *Harden*, 434 N.W.2d at 885.

Dividends from foreign subsidiaries are taxed differently from those received from domestic subsidiaries, because Iowa bases "net income" on the taxable income figure reported on the federal income tax return. *See* Iowa Code § 422.33. As we said in *First National Bank of Ottumwa v. Bair*, 252 N.W.2d at 723, 726 (Iowa 1977):

> The result is practical. The taxpayer is permitted to merely lift the figures off the federal return and transfer them to the Iowa franchise tax return. The Department of Revenue receives the

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[3] Suspect classifications generally are based on race, alienage, or national origin. Fundamental rights include the right to vote, the right of interstate travel, and other rights, such as those guaranteed by the First Amendment, which are considered essential to individual liberty. *Bennett*, 446 N.W.2d at 473 (citations omitted).

benefit of the regulations and interpretations of the federal agency.

The coupling of Iowa net income with the federal formula is convenient for the taxpayer, prevents the taxpayer from spending time and money on complex forms, provides a saving to the state, allows the state to rely on federal regulation and interpretation, and provides the state with an inexpensive and quick way of verifying the accuracy of taxpayers' returns. We hold that the use of the federal net income figure for computing Iowa franchise tax "net income" is a legitimate purpose.

Kraft argues that Iowa's taxing scheme is not rationally related to achieving conformity with the federal system. This is because Iowa does not follow the internal revenue code in allowing a tax credit to corporations who pay foreign taxes on foreign dividends. However, complete conformity to the federal tax system is not the legitimate purpose claimed. The legitimate state purpose is to couple Iowa "net income" with federal taxable income, with the resulting advantages outlined above. It is a familiar principle that a "statute is not invalid under the Constitution because it might have gone farther than it did." *Katzenbach v. Morgan*, 384 U.S. 641, 657, 86 S. Ct. 1717, ___, 16 L. Ed. 2d 828, 839 (1966) (quoting *Roschen v. Ward*, 279 U.S. 337, 339, 49 S. Ct. 336, ___, 73 L. Ed. 722, 729 (1929)).

We hold that the income tax statutes in question, Iowa Code §§ 422.33, 422.35, are not invalid under the equal protection clauses of either the United States or Iowa Constitution.

We find no error in the district court ruling and therefore affirm.

AFFIRMED.

APPENDIX B

IN THE DISTRICT COURT OF IOWA
IN AND FOR POLK COUNTY

Case No. AA-1399

FINDINGS OF FACT,
CONCLUSIONS OF LAW,
AND JUDGMENT

KRAFT, INC.

Plaintiff,

vs.

IOWA DEPARTMENT OF REVENUE AND FINANCE,

Defendant.

This cause of action came on before this Court, the parties being represented by counsel. This is a judicial review of final agency action of the Iowa Department of Revenue and Finance instituted by Kraft, Inc. Jurisdiction is by and pursuant to the Iowa Code Chapter 17A.

"FINDINGS OF FACT"

There was a stipulation of the parties and exhibits thereto which is incorporated by reference. A contested case proceeding was before the Director of Revenue and Finance, J.D. Bair, August 16, 1988. On August 18, 1988, the Director of the Department issued a final order in which he concluded that he lacked authority to decide the issues contested which involved facial constitutionality of tax statutes. He further decided he had no authority to decide whether any decision on these issues should be applied prospectively only. The petition for review was then filed with this Court to review the Director's order. This Court finds it has jurisdiction pursuant to Section 17A, 19

the Iowa Code. The relevant facts are not in dispute and the Court proceeds under the stipulated facts.

Kraft, Inc. is a corporation duly organized and existing under the laws of the State of Deleware (sic), with its principle office and commercial domicile located in the State of Illinois, and qualified to do business in the State of Iowa. During 1981, Kraft owned capital stock representing more than 80% of the total voting power and total value of several corporations organized and conducting their respective business exclusively outside the United States, which corporations were not subject to United States income tax. These types of subsidiary corporations located in foreign countries are known as "foreign subsidiaries".

In 1981, Kraft's foreign subsidiaries declared and paid dividends to Kraft. The foreign countries in which these foreign subsidiaries were located required the subsidiaries to withhold income taxes imposed by the countries upon the declared dividends of Kraft and to remit such taxes. In addition, the foreign subsidiaries were taxed directly by the foreign countries upon their earnings, from which the dividends to Kraft were declared. Thus, the foreign countries, utilizing the "arms-length" approach to income taxation, taxed the earnings represented by the foreign dividends twice, once to the foreign subsidiaries and second to Kraft.

In 1981, the Internal Revenue Code, for federal income tax purposes, allowed a deduction in computing a domestic corporation's federal taxable income equal to 100% of non-qualifying dividends received from domestic subsidiaries. However, a domestic corporation such as Kraft, which received dividends from foreign subsidiaries, was not permitted to deduct those dividends in computing the domestic corporation's federal taxable income. Instead, a domestic corporation which received foreign subsidiary dividends could elect to claim, on the domestic corporation's federal

income tax return, a credit against its federal income tax for the foreign taxes paid. Alternatively, the Internal Revenue Code allowed a domestic corporation dividend payee who received foreign subsidiary dividends to claim a deduction for foreign taxes paid, rather than a tax credit, against its federal taxable income on its federal income tax return. Kraft elected the tax credit.

In 1981, Iowa imposed a corporation income tax, in Iowa Code Section 422.33, upon corporations carrying on all of their business in Iowa. In addition, the statute imposed the tax upon the income producing activities of all corporations, such as Kraft, which did business within and without Iowa.

The Iowa tax was imposed upon corporate "net income" as defined in Iowa Code Section 422.35 that was attributable to Iowa. Section 422.35 defined "net income" as the taxable income before the net operating loss deduction as properly computed for federal income tax purposes under the Internal Revenue Code of 1954, with certain adjustments, none of which are relevant to this case. Unlike the federal income tax scheme, Iowa did not permit a credit against a domestic corporation's Iowa income tax liability for income or other taxes paid to foreign governments. Since Section 422.35 is coupled with federal taxable income, if a corporate taxpayer elected to deduct taxes paid to foreign governments in determining its federal taxable income, it could likewise deduct such taxes in determining Section 422.35 net income.

In its 1981 federal income tax return, Kraft included the dividends declared by the foreign subsidiaries in its federal taxable income, as required by the Internal Revenue Code, and claimed a foreign tax credit against a portion of its federal income tax liability. In computing its Iowa net income in the preapportioned net income base, Kraft, on its 1981 Iowa income tax return, deducted the foreign subsidiary dividends from that base, contrary to

the requirements of Iowa Corporate Income Tax Law in Section 422.33(2)(b) and 422.35.

On June 3, 1985, the Director of the Department of Revenue and Finance issued a notice of assessment for Iowa corporation income tax against Kraft for its 1981 tax year. A portion of the assessed deficiency was based upon the effect of Kraft's exclusion of the foreign subsidiary dividends from Kraft's preapportioned net income base.

"CONCLUSIONS OF LAW"

This case involves judicial review under Iowa Code 17A, of a contested case proceeding in which the issues raised by the parties were beyond the authority of the agency to decide. In the administrative contested case proceeding before the Iowa Department of Revenue and Finance, its Director issued an order in which he stated that he lacked authority to decide Kraft's facial constitutional challenge to an Iowa corporate income tax assessment for 1981. "Where issues decided by an administrative agency involve potential constitutional questions, these constitutional issues must first be raised before the agency in order to be considered by a court in reviewing the final agency action under Iowa Code Section 17A.19 *Shell Oil Co. v. Bair*, 417 NW2d 425, 429 (1987). The Iowa Supreme Court has stated that notwithstanding the agency's lack of authority to make constitutional determinations, these issues are more effectively presented for adjudication based upon a specific factual record and the place for such a record to be developed is before the agency. *Id.* at 430.

Iowa Code Section 17A.19(1) provides, however, "that if an agency declines to issue a declaratory ruling after receipt of a petition therefor, any administrative remedy available under Section 17A.19 shall be deemed inadequate or exhausted." Since the Director of the Department of Revenue and Finance declined to determine the facial constitutional question, this is sufficient for satisfying the exhaustion waiver language in Section 17A.19(1). *Id.*

In determining the constitutionality of a statute, courts do not "pass on the policy, wisdom, advisability, or justice of a statute." *City of Waterloo v. Selden*, 251 NW2d 506, 508. In addition, "all presumptions are in favor of the constitutionality of the statute and it will not be held invalid unless it is clear, plain, and palpable that such decision is required." Plaintiffs have the burden to demonstrate beyond a reasonable doubt the act violates the constitutional provision and every reasonable doubt is resolved in favor of constitutionality. *Id.* "The presumption in favor of constitutionality is especially strong where, as here, the statute was enacted to promote a public purpose and relates to taxation." *Lee Enterprises Inc. v. Iowa State Tax Commission*, 162 NW2d 730, 739.

THIS COURT NOW DRAWS CERTAIN CONCLUSIONS:

I. The Iowa Tax Does Not Discriminate Against Interstate Commerce.

Kraft, Inc. challenges the constitutionality of Iowa's corporate income tax because corporate taxpayers doing business in Iowa with domestic subsidiaries receive a tax exemption while those like Kraft with subsidiaries abroad do not receive such an exemption. This is facially discriminatory in violation of the Commerce Clause, alleges Kraft, because corporations "are given a direct competitive advantage based upon whether they and their subsidiaries are engaged in interstate commerce as compared with those which are engaged in foreign commerce."

According to *Complete Auto Transit v. Brady* a state tax is not an impermissible burden on interstate commerce if it 1) it (sic) is applied to an activity with a substantial nexus with the taxing state 2) is fairly apportioned; 3) does not discriminate against interstate commerce; 4) and is fairly related to the services provided by the state. Kraft

does not challenge the fact that its business has a substantial nexus with Iowa, is fairly apportioned and is fairly related to services provided by the state. Instead, Kraft's challenge centers around the effect the tax has on interstate commerce and this Court will therefore concentrate on that aspect of the *Complete Auto* test only.

In supporting its claim that Iowa's tax is discriminatory, Kraft cites a number of cases in which the Supreme Court struck down a state tax held to be in violation of the Commerce Clause. The cases cited, however, all involve a state giving special treatment to a local in-state industry at the expense of an out-of-state industry. *Armco v. Hardesty*, 104 S.Ct. 2620 (Local manufacturers exempt from gross receipt tax on their sales at wholesale); *Tyler Pipe Industries v. Washington Dept. of Revenue*, 107 S.Ct. 2810 (1987) (Washington state gross receipts tax exempted in-state wholesale sales by a local manufacturer but taxed sales to out-of-state buyers); *Bacchus Imports, Ltd. v. Dias*, 104 S.Ct. 3049 (1984) (Hawaii exempted locally produced brandy and fruit wine from an excise tax imposed on liquor produced abroad); *Westinghouse Electric Corporation v. Tully*, 104 S.Ct. 1856 (1984) (tax credit limited to gross receipts of products shipped from New York). Kraft has not shown that the Iowa tax in any way benefited local in-state industry in detriment to out-of-state industry. Kraft attempts to fit the Iowa tax into the category of those found unconstitutional by stating that the discrimination does not have to be intentional to be unconstitutional. This is certainly true. But Kraft misses the next step in that if a state tax does not deliberately discriminate it must at least have the practical effect of discriminating against interstate commerce. Kraft has not shown this. The best that Kraft can do is to say that the Iowa tax is discriminatory because a corporation doing business in Iowa pays more corporate income tax if it has foreign subsidiaries than if it has domestic subsidiaries and this discrimination based on the residence is a violation of the Commerce

Clause. Assuming for the sake of argument that this is empirically true,[1] Kraft has not shown discrimination since this greater tax burden affects an in-state Iowa industry doing business abroad in the same way that it affects an out-of-state corporation like Kraft. Kraft has not shown that the Iowa tax exerts a pressure on interstate business to conduct more of its activities in Iowa. Despite this, Kraft argues that the Iowa tax is protectionist in that if all states had a tax scheme such as Iowa, it would be a "powerful persuader" to locate foreign operations within U.S. boundaries. Aside from the wholly speculative nature of this argument, Kraft's argument must fail because it overestimates the power of a state or this Court to do something about a situation that is the province of Congress. "Foreign commerce is preeminently a matter of national concern." *Japan Line* at 1821. "The threat of double taxation from foreign taxing authorities has no role in Commerce Clause considerations of multiple burdens. The Commerce Clause mandates apportionment among the several states but "apportionment among nations is a matter for international agreement; it should not be considered a limitation on a state's power to tax. *Sea Land*, 177 Cal. Rprtr. 448 (1974).

Even accepting Kraft's worst case scenario, this would be a case where independent state policy would have to yield to an overriding national interest. It is the legislature with the power granted by the Commerce Clause that would enact this legislation. *Moorman Manufacturing v. Bair*, 98 S.Ct. 2340, 2348 (1978). "The remedy for those who contend that legislation which is within constitutional bounds is unwise or oppressive is with the legislature." *City of Waterloo v. Selden*, 251 N.W.2d 506, 509.

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[1] It is not necessarily true since the total amount of income tax owed by the corporation doing business abroad would depend on the tax credits and deductions given by the foreign government. Therefore, it is not necessarily true that foreign commerce is disadvantaged. *Container Corp. of America v. Franchise Tax Bd.*, 103 S.Ct. 2952 (1983).

In fact, Congress has legislated in this area since it allows a tax credit or deduction for dividend income from foreign subsidiaries in the Internal Revenue Code. Kraft, however, has not set forth any language that evidences a Congressional intent to apply this to states and "absent some explicit directive from Congress, we cannot infer the treatment of foreign income at the federal level mandates identical treatment by the states." *Mobil Oil v. Commissioner of Taxes of Vermont*, 100 S.Ct. 1223, 1237 (180) (sic).

II. The Iowa Tax Does Not Impose an Impermissible Multiple Tax on Kraft.

Kraft correctly states that when a foreign instrumentality of commerce is at issue as it is here, two more prongs are added to the four already cited in *Complete Auto* in determining whether a state tax is constitutional. The first is the enhanced risk of multiple taxation. Second, a state tax on the instrumentality of foreign commerce must be scrutinized to make sure it does not impair federal uniformity in an area where federal uniformity is essential. *Japan Line Ltd. v. County of Los Angeles*, 99 S.Ct. 1813, 1820-1821 (1979). Kraft challenges the Iowa tax based on what it avers to be a risk of multiple taxation. Since Kraft has not raised the second issue of *Japan Line* of whether a tax will impair federal uniformity, it will not be discussed. Instead, this Court will discuss whether the tax creates a substantial risk of multiple taxation and is unconstitutional under the Commerce Clause.

Japan Line involved property taxes levied on Japanese-owned shipping companies engaged exclusively in foreign commerce. California levied the tax on the vessels even though the ships were there only intermittently and even though the ships were already taxed by their home ports in Japan. The Supreme Court held that the tax was unconstitutional because it subjected the Japanese Companies to multiple taxation. In order to prevent multiple taxation,

courts require that "taxes be apportioned among taxing jurisdictions, so that no instrumentality of commerce is subjected to more than one tax on its full value." *Id* at 1820. Kraft argues that the Iowa tax represents the fourth layer of taxes of its foreign subsidiary dividend income and is therefore unconstitutional under *Japan Line*. Kraft says that the dividend income was taxed by the foreign government on both the subsidiary and the domestic parent corporation, by the federal government, and, finally, by the Iowa corporate income tax. The multiple taxation prong of *Japan Line*, however, requires something more than simply adding up the income subject to tax as Kraft would have this Court do. As Respondent correctly points out, Kraft's bare listing of taxes is deceiving since the foreign government, rather than imposing two taxes, could have imposed one tax at a higher rate equivalent to the two. Further, the fact that Kraft is subject to taxing by a foreign government "does not conclusively demonstrate the existence of double taxation because [Kraft] has not produced its foreign tax returns, and it is entirely possible that deductions, exemptions, or adjustments in those returns eliminated whatever overlap in taxable income resulted from the application of the [Iowa] apportionment method." *Container Corp. of America v. Franchise Tax Bd.*, 103 S.Ct. 2933, 2952 (1983). The listing is also deceptive because it does not reflect the fact that Kraft received a credit on its federal income tax to offset the foreign taxes paid.

It is for the above reasons that the prohibition against multiple taxation is not an absolute rule but must instead "take into account the context in which the double taxation takes place and the alternatives reasonable (sic) available to the state." *Id.* at 2953. *Container Corp.* involved a refusal by a corporation which had a number of overseas subsidiaries to include its subsidiaries payroll, property, and sales in its California income tax apportionment. *Container Corp.* held that a California tax was constitutional

despite the fact that like the one in *Japan Line*, it resulted in double taxation to the corporation. Some of the income that was already taxed without apportionment by foreign nations as attributable to foreign subsidiaries was taxed by California as well as attributable to the state's share of the total income of the unitary business. *Container* at 2952. The court in *Container Corp.* found a number of distinctions between the tax at issue and the one in *Japan Line*. Unlike *Japan Line* the Court found that the double taxation was not the inevitable result of the California taxing scheme. *Id.* at 2952. It was also important to the Court's analysis that the tax fell on a corporation domiciled and headquartered in the United States rather than on foreign owners of an instrumentality of commerce. *Id.* It said it was unrealistic for California to avoid double taxation simply by not taxing Container Corp.'s income at all since this would be obviously unfair to the state. *Id.* This Court finds that the Iowa tax is more like the tax found to be constitutional in *Container Corp.* than the tax found to be unconstitutional in *Japan Lines* (sic).

Of great concern in *Japan Line* and the reason for the addition of the two prongs to the *Complete Auto* test was that the overlapping of tax was imposed on a foreign company in a foreign jurisdiction. This implicated "sensitive matters of foreign relations and natural sovereignty." *Japan Line* at 1825. While a foreign government might have some concern over how a domestically owned subsidiary that is doing business in its country is taxed at home, this concern is much more attenuated than it was in *Japan Line*. This Court finds that *Container Corp.* is directly applicable to the tax by the Iowa Department of Revenue and that the distinction between a tax on a domestically owned corporation engaged in foreign commerce and the tax at issue in *Japan Line* add up to a constitutionally significant difference. *Container* at 2952-2953. Important to this conclusion is the fact that the Supreme Court addressed a situation involving dividends like the

one at issue here in the *Container Corp.* opinion: "Moreover, once the Federal government has allowed a credit for foreign taxes on a particular intercorporate dividend, we are not persuaded why, as a logical matter, a State would have to grant another credit of its own, since the federal credit would have already vindicated the goal of not subjecting the taxpayer to a higher tax burden than it would have to bear if its subsidiary's income were not taxed abroad." 103 S.Ct. 2954, FN 30. This Court finds that like the tax at issue in *Container Corp.*, the Iowa tax is not an impermissible burden on foreign commerce.

Once Kraft's complaint that the Iowa tax results in multiple taxation is taken out of the context of the sensitive area of foreign relations and *Japan Line*, it essentially boils down to a complaint that since the federal government allows credits and deductions for taxes paid on foreign subsidiary dividends, Iowa should too. But Kraft sets forth no reason why this should be so. Concurrent federal and state taxation of income is a well-established norm. *Mobil Oil v. Comm'r of Taxes of Vermont*, 100 S.Ct. 1223, 1237 (1980). Kraft has not set forth any language from the legislative history mandating identical treatment of the dividend income for tax purposes and "absent some explicit directive from Congress, we cannot infer that treatment of foreign income at the federal level mandates identical treatment by the states." *Id.* See also *Shell Oil Company v. Iowa Dept. of Revenue*, 109 S.Ct. 278, 281 (1988).

In *Amerada Hess Corp. v. Director Division of Taxation*, thirteen major oil companies challenged a New Jersey corporate business tax that denied them the deduction on state income tax that they received under the federal windfall profits tax. The Supreme Court found that the tax did not violate any of the four tests of *Complete Auto* and therefore was constitutional, 109 S.Ct. 1617 (198) (sic). As there was no requirement that New Jersey give a tax credit or a deduction similar to the one given at the federal

level in *Amerada*, Iowa is similarly not required to give Kraft a tax credit that it received at the federal level. In fact, the Iowa Supreme Court dealt with this situation explicitly in *Shell Oil Co. v. Bair* where Shell argued that a state tax deduction for the federal windfall profit tax was constitutionally mandated. 417 N.W.2d 425 (Iowa 1987). The Iowa Supreme Court said that Shell's liability for the Iowa corporate income tax depended on the nexus of Shell's activities within this state and the fairness of the apportionment formula used in calculating it. While the preceding two factors must be validated, once it is determined that they are fair measurements for gross revenue purposes, "the extent to which these revenues may be reduced for tax purposes by allowable deductions is a matter of legislative grace." *Id.* at 430.

Kraft doesn't challenge the Iowa tax on the basis of insufficient nexus or unfair apportionment. Indeed, it would be hard pressed to do so in light of *Mobil Oil Corp. v. Com'r of Taxes of Vermont*, 100 S.Ct. 1223, 1226 (neither the foreign source of the income of a corporation nor the fact that it was received in the form of dividends from subsidiaries and affiliates precludes its taxability by a state) and *Moorman Manufacturing Company v. Bair*, (Iowa's method of calculating taxable income held to be fair apportionment and constitutionally acceptable) 98 S.Ct. 2340 (1978). Kraft simply has not shown that the aggregate sum which remains subject to tax, absent a credit for its foreign subsidiary taxes, is an invalid measurement of its Iowa income tax liability. *Shell Oil v. Bair*, 417 N.W.2d at 430-31. The tax credit at issue here, like the deduction in *Shell Oil* is therefore a "matter of legislative grace."

III. The Iowa Tax Does Not Violate The Equal Protection Clause.

Kraft next argues that the Iowa tax on corporations violates the Equal Protection Clause of the U.S. Constitution and Article 1, No. 6, of the Iowa Constitution. The

Complete Auto test encompasses due process standards. *Amerada*, 109 S.Ct. at 1625. Since the Iowa tax does not violate the four tests of *Complete Auto*, this Court also concludes that it does not violate due process. *Id.* Further, Kraft's reliance on *Metropolitan Life Ins. v. Ward* is inappropriate here since this Court has determined that the Iowa tax is not designed to favor industry within the state to the detriment of out-of-state corporations. In addition, the Iowa Department of Revenue and Finance rationale for adopting the Internal Revenue Code's definition of net income: "for the convenience of the taxpayer, as a savings to the state, and to provide the state with a means of verifying the accuracy and honesty of a taxpayer's return" is rationally related to a legitimate state purpose. 105 S.Ct. 1676 (1985).

In sum, this Court finds no constitutional infirmity with the Iowa Business Corporation Tax. Because this Court does not find the tax facially invalid as alleged by Kraft, there is no reason to reach the issue of whether the ruling should be prospectively applied to other taxpayers.

JUDGMENT

IT IS THE JUDGMENT OF THIS COURT that Kraft's Petition for Judicial Review is dismissed. Costs taxed to the Plaintiff.

8 September 1989 /s/ Theodore H. Miller
THEODORE H. MILLER, JUDGE
FIFTH JUDICIAL DISTRICT OF IOWA

A copy of this ruling has been
mailed to the attorneys for Kraft, Inc.
and to the attorneys for the Iowa
Department of Revenue and Finance.

APPENDIX C

**BEFORE THE IOWA STATE DEPARTMENT OF REVENUE AND FINANCE
HOOVER STATE OFFICE BUILDING
DES MOINES, IOWA**

DOCKET NO. 85-330-2A-A

ORDER

IN THE MATTER OF KRAFT, INC.
2211 SANDERS ROAD
NORTHBROOK, IL 60062

CORPORATE INCOME TAX ASSESSMENT

STATEMENT OF THE CASE

The instant contested case proceeding came on for hearing before the Director of Revenue and Finance on the 16th day of August, 1988. Present on behalf of the Protestor were John V. Donnelly and Harold N. Schneebeck, attorneys and authorized representatives for Protestor. Present on behalf of the Department of Revenue and Finance was Harry M. Griger, Special Assistant Attorney General and authorized representative of the Department.

Protestor offered in evidence the following portions of the Stipulation of the parties: paragraphs 1 through 21; paragraph 22 except for the portion denoted "Cross Examination" on page 13; paragraphs 23, 25, 26, 27(c), 32 and 33; and Exhibits 1 through 11 thereto. The Department offered in evidence the "Cross-Examination" portion of paragraph 22, on page 13, paragraphs 24, 27(a), (b) and (d) and 28 through 31 and paragraph 34 of the Stipulation and Exhibits A through J thereto. Protestor objected to the admission of paragraphs 24, 27(a), (b) and (d) and 28

through 31 and paragraph 34 of the Stipulation on the ground that they are irrelevant because there is no dispute between the parties as to the effect on Protestor of a decision favorable to it. Protestor also objected to the admission of Exhibits C through J to the Stipulation on the ground that they are irrelevant for the same reason.

The principal issue raised by the Protestor to be determined in this proceeding is whether the Iowa Business Tax on Corporations (Division III of Chapter 422, *Code of Iowa*) is unconstitutional on its face to the extent that it requires a Domestic Corporation to include in its "net income" (as that term is defined in § 422.35, *Code of Iowa*) dividends declared by its Foreign Subsidiaries whereas dividends declared by Domestic Subsidiaries are excluded from such net income. Other issues raised by the Protestor are: (i) whether the Iowa Business Tax on Corporations, considered with income taxes imposed by the United States and foreign governments with respect to such dividends declared by Foreign Subsidiaries and the income from which the dividends were declared, results in facially unconstitutional multiple taxation; and (ii) whether the Iowa Business Tax on Corporations to the extent of its treatment of dividends declared by Foreign Subsidiaries facially results in an unconstitutional contravention of the foreign policy of the United States and thereby denies to the federal government its constitutional role as the single controlling voice in foreign affairs. Specifically, this contested case proceeding involves the following provisions of the Constitution of the United States and/or the Constitution of the State of Iowa:

> Article I, Section 8, clause 3 of the Constitution of the United States (the Commerce Clause);
>
> The Due Process Clause of Section 1 of the Fourteenth Amendment to the Constitution of the United States;

The Equal Protection Clause of Section 1 of the Fourteenth Amendment to the Constitution of the United States;

The Supremacy Clause of Article VI, Clause 2 of the Constitution of the United States;

The Due Process Clause of Article I, Section 9 of the Constitution of the State of Iowa;

The uniform operation of laws provisions of Article I, Section 6 and Article III, Section 30 of the Constitution of the State of Iowa.

If the Iowa Business Tax on Corporations is found to be facially unconstitutional with respect to one or more of the issues raised by the Protestor, the Department raises the further issue to be determined in this proceeding of whether such a decision shall be applied to other taxpayers prospectively only, and, if so, the scope of any such prospective ruling.

FINDINGS OF FACT

The parties' Stipulation is hereby adopted as the Findings of Fact of the Director of Revenue and Finance. Said Stipulation is attached to this Order and incorporated herein by reference the same as if set forth in full. Protestor's objections to the admission of paragraphs 24, 27(a), (b) and (d) and 28 through 31 and paragraph 34 of the Stipulation and Exhibits C through J thereto offered by the Department are overruled.

CONCLUSIONS OF LAW

The Director of Revenue declines to render a decision in this case on the grounds that he has no authority to decide the facial constitutionality of statutes and, further, that he has no authority to decide whether any such decision should be applied prospectively only.

This Order is the final Order of the Director of Revenue and Finance and is subject to judicial review pursuant to §§ 422.41 and 422.29, *Code of Iowa*.

ISSUED at Des Moines, Iowa, this *18th* day of August, 1988.

IOWA DEPARTMENT OF REVENUE
AND FINANCE

By s/G.D.Bair
G. D. Bair, Director of
Revenue and Finance

APPENDIX D

BEFORE THE IOWA STATE DEPARTMENT OF REVENUE AND FINANCE HOOVER STATE OFFICE BUILDING DES MOINES, IOWA

DOCKET NO. 85-330-2A-A

STIPULATION

IN THE MATTER OF KRAFT, INC.
2211 SANDERS ROAD
NORTHBROOK, IL 60062

CORPORATE INCOME TAX ASSESSMENT

COME NOW the Iowa Department of Revenue and Finance and Kraft, Inc., and hereby stipulate and agree, for the purposes of this action only, that the following facts may be accepted as true and correct, that the documents attached hereto are true and genuine copies of the respective original documents and may be offered into evidence without further foundation, and that this stipulation shall constitute evidence in the above-captioned matter and in all proceedings for judicial review thereof, subject to the rights of either party to object on the grounds of relevance and to present additional evidence not inconsistent herewith:

1. Kraft, Inc., is a corporation duly organized and validly existing under the laws of the State of Delaware, with its principal office and commercial domicile located in the state of Illinois, and qualified to do business in the state of Iowa.

2. Kraft, Inc., was formerly named Dart & Kraft, Inc., and is the successor by merger to a former subsidiary of Dart & Kraft, Inc., which was also named Kraft, Inc. For

the purpose of clarity, the merged subsidiary shall hereinafter be referred to as "Old Kraft."

3. The Iowa Department of Revenue and Finance (hereinafter sometimes referred to as the "Department") is a duly constituted agency of the State of Iowa created effective January 1, 1968, by the Sixty-Second General Assembly of the Iowa Legislature as the successor to the State Tax Commission of Iowa and was reorganized pursuant to 1986 Iowa Acts, ch. 1245, §§ 401-450. G. D. Bair is the duly appointed Director of Revenue and Finance of the State of Iowa.

4. During the calendar year 1981, Old Kraft was a corporation duly organized and validly existing under the laws of the State of Delaware, with its principal office and commercial domicile located in the state of Illinois and qualified to do and doing business in the state of Iowa. Old Kraft constituted a unitary business, a portion of which was conducted in the state of Iowa.

5. Old Kraft filed an Iowa corporate income tax return for the calendar year 1981 and paid the amount of tax shown to be due thereon.

6. During the year 1981, Old Kraft owned capital stock representing more than eighty percent (80%) of the total voting power and total value of several corporations organized and conducting their respective businesses exclusively outside the United States, which corporations were not subject to United States income tax. For the sake of brevity, subsidiary corporations of this type will hereinafter sometimes be referred to in general as "Foreign Subsidiaries."

7. Attached hereto as Exhibit "1" is a schedule setting forth the names and nations of incorporation of certain Foreign Subsidiaries of Old Kraft which paid dividends to Old Kraft during 1981. The Foreign Subsidiaries listed in Exhibit "1" were required to pay, and in fact paid, to the

countries in which they were incorporated, income tax on that portion of their income from which the "dividends declared" shown in Exhibit "2" were paid (see also paragraph 16, *infra*).

8. Attached hereto as Exhibit "2" is a schedule setting forth: (i) the dividends declared to Old Kraft by the Foreign Subsidiaries listed in Exhibit "1" in the year 1981; (ii) the income taxes borne directly by Old Kraft, on account of said dividends, imposed by the nations of the dividend payors' incorporation, and withheld and remitted thereto by said payors (the "foreign income taxes withheld"); and (iii) the net amount [(i) less (ii)] that was repatriated to and received by Old Kraft.

9. For ease of reference, corporations organized and conducting their businesses exclusively outside the United States, which corporations are not subject to United States income tax, will hereinafter sometimes be referred to as "Foreign Corporations." Old Kraft's Foreign Subsidiaries were "Foreign Corporations" throughout 1981. Corporations organized under the laws of one of the states of the United States and subject to taxation under Chapter 1 of the Internal Revenue Code will hereinafter sometimes be referred to as "Domestic Corporations." Domestic Corporations whose dividends are "qualifying dividends" to recipient Domestic Corporations under section 243(b)(1) of the Internal Revenue Code will hereinafter sometimes be referred to as "Domestic Subsidiaries." The phrase "foreign governments" as used in this Stipulation means non-United States governments.

10. Domestic Corporations typically do business in foreign countries through corporations organized in the country in which they are doing business for a variety of reasons. Reasons include, but are not limited to, the requirements of the local country, a better ability to limit their liability in that country, the marketing advantage of being perceived by customers as a local company, greater

ease in repatriating funds, greater ease in borrowing funds locally, and ability to own property and manufacture in that country.

11. During the year 1981, §§ 241 and 243 of the Internal Revenue Code allowed a deduction in computing a Domestic Corporation's federal taxable income equal to 100% of the dividends it received from Domestic Corporations which were members of the same affiliated group of corporations (Domestic Subsidiaries). If the domestic dividend payor and payee were not members of the same affiliated group of corporations, the dividend payee was granted a deduction equal to 85% of the dividends it received from the domestic dividend payor.

12. During the year 1981, a Domestic Corporation which received dividends with respect to shares of stock which it owned in Foreign Corporations was not permitted to deduct such dividends in computing the Domestic Corporation's federal taxable income.

13. During the year 1981, the Internal Revenue Code permitted a Domestic Corporation which received dividends from Foreign Corporations to elect to claim on its (Domestic Corporation's) federal income tax return as a credit against its federal income tax a portion of the income and certain other taxes, if any, paid by the Foreign Corporations (dividend payors) to foreign governments as well as a portion of any foreign income taxes paid by the dividend payee (whether directly or by withholding) with respect to the dividend. The amount of the foreign tax credit available for use by the payee was limited by the Internal Revenue Code. Alternatively, the Internal Revenue Code permitted a Domestic Corporation (the dividend payee) to claim as a deduction on its federal income tax return the foreign income taxes withheld with respect to the dividend it received from Foreign Corporations in the determination of its federal taxable income.

14. During the year 1981, § 422.35, *Code of Iowa*, defined "net income" as the taxable income before the net operating loss deduction, as properly computed for federal income tax purposes under the Internal Revenue Code of 1954, with certain Iowa adjustments, none of which mentions dividends declared by Foreign Corporations.

15. During the year 1981, the Iowa Code did not permit a credit against a Domestic Corporation's Iowa income tax liability for income or other taxes paid to foreign governments with respect to dividends declared by Foreign Corporations to the Domestic Corporation.

16. In determining its taxable income for federal income tax purposes for the year 1981, Old Kraft included in its income computation: (i) the dividends declared by its Foreign Subsidiaries; and (ii) the foreign income taxes paid by the dividend-paying Foreign Subsidiaries on the income out of which the dividend was paid (the "gross-up"). In computing its federal income tax liability for 1981, Old Kraft claimed as a credit against its U.S. income tax an amount equal to a portion of the foreign income tax withheld with respect to the dividends plus a portion of the gross-up amount.

17. In computing its "net income" on its Iowa corporate income tax return for the year 1981, Old Kraft deducted from its federal taxable income: (i) the dividends declared to Old Kraft by the Foreign Subsidiaries during that year; and (ii) the gross-up included in Old Kraft's taxable income for federal purposes.

18. Under date of June 3, 1985, G. D. Bair, Director of Revenue of the State of Iowa, issued a Notice of Assessment for Corporation Income Tax against Old Kraft relating to its alleged liability for additional Iowa corporate income tax, interest and fees for the calendar year 1981. Said assessment assessed tax, interest and fees as follows:

Periods	Tax	Penalty	Interest	Fees	Total
81-12	$39,327,64(sic)	-	$12,427.53	1.45	$51,756.62

19. A portion of the deficiency in Iowa corporate income tax which was alleged in the Notice of Assessment to be owed by Old Kraft for the year 1981 was based on the assertion by the Department that for the year 1981 all dividend income declared by its Foreign Subsidiaries to Old Kraft should be included in the computation of the "net income" of Old Kraft under section 422.35, *Code of Iowa*. Also, the Department asserted that the income taxes withheld by foreign governments with respect to such dividends could not be deducted by Old Kraft in the computation of its "net income" because these taxes were not deducted by Old Kraft in the determination of its federal taxable income. Both parties agree that pursuant to Department Rule 701 Iowa Admin. Code 54.2(3), gross-up will not be used to augment Old Kraft's business income.

20. The dividend income declared by the Foreign Subsidiaries to Old Kraft is includable in Old Kraft's net income pursuant to § 422.35, *Code of Iowa*, and such dividend income is "business income" within the meaning of §§ 422.32(6) and 422.33(2)(b), *Code of Iowa*. Old Kraft constituted a unitary business, a portion of which was conducted in Iowa for 1981. The dividends declared by the Foreign Subsidiaries were part of Old Kraft's unitary business income.

21. Had Old Kraft's Foreign Subsidiaries been Domestic Corporations conducting their respective businesses exclusively outside the United States, the dividends which they declared to Old Kraft in 1981 would, under authority of the Internal Revenue Code, have been deducted in determining Old Kraft's federal taxable income and, therefore, in determining "net income" (as that term is defined in section 422.35, *Code of Iowa*) for Iowa income tax purposes.

22. If called as an expert witness in this case by Kraft, Inc., Roger Jacobsen would testify as follows:

DIRECT EXAMINATION

Q. Would you state your name, please?

A. Roger Jacobsen.

Q. And what is your address?

A. 3405 Woodland Avenue, West Des Moines.

Q. Mr. Jacobsen, what is your present occupation?

A. I am a partner with the public accounting firm of Peat Marwick Main.

Q. And in what office are you located?

A. The Des Moines, Iowa, office.

Q. Would you describe for us briefly what Peat Marwick Main and Company is and does?

A. It is a certified public accounting firm which deals with auditing, tax services and management consultants.

Q. How long have you been associated with Peat Marwick and Main?

A. Since 1971.

Q. And when did you become a partner?

A. 1980.

Q. In what areas do you concentrate your practice?

A. Primarily in the federal and state income tax area, dealing with commercial manufacturing clients.

Q. Is that the corporate income tax area?

A. Yes, corporate area.

Q. What college did you attend?

A. The University of Nebraska.

Q. What degree did you receive, if any?

A. Bachelor of Science in Business Administration, with a major in accounting in 1971.

Q. Do you hold any licenses or certificates connected with the accounting profession?

A. I am a Certified Public Accountant.

Q. Are you a member of any professional organizations?

A. Yes. I am a member of the American Institute of Certified Public Accountants and the Iowa Society of Certified Public Accountants.

Q. In connection with your profession, are you required to meet certain professional education requirements?

A. Yes, we are. The firm requirement is we have to have 20 hours of continuing education credits every year, with a minimum of 120 hours every three years.

Q. A 40-hour average, essentially?

A. That is correct.

Q. In what areas do you concentrate most of your continuing education?

A. Primarily in the commercial, corporate and partnership income tax area.

Q. Mr. Jacobsen, do you have any financial interest in Kraft, Inc., or any of its affiliates?

A. No.

Q. Are you an employee or officer of Kraft, Inc., or any of its affiliates?

A. No.

Q. Are Kraft, Inc., or any of its affiliates clients of Peat Marwick Main?

A. No, they are not.

Q. Are you being paid a fee in this case?

A. Yes, I am.

Q. Is your fee contingent in any manner on the results of this case?

A. No.

Q. Are you familiar with the pleadings, the Stipulation and exhibits which have heretofore been filed in this case?

A. Yes, I am.

Q. Now from your experience as a CPA, are you familiar with how dividends received by U.S. corporations from other corporations were treated for federal and Iowa income tax purposes during the year 1981?

A. Yes, I am.

Q. Mr. Jacobsen, this case concerns the treatment for Iowa corporate income tax purposes of dividends which United States corporations subject to Iowa income tax receive from what the parties have defined in the Stipulation as Foreign Subsidiaries. For ease of reference, may we refer to this type of dividend payor as a Foreign Subsidiary?

A. All right. Yes.

Q. Likewise, for ease of reference, may we refer to the dividend recipient as the Parent Corporation?

A. That would be fine.

Q. From your experience as a CPA, are you familiar with how dividends received by Parent Corporations from their Foreign Subsidiaries were treated for federal and Iowa income tax purposes during the calendar year 1981?

A. Yes, I am.

Q. Are you prepared to explain that treatment now?

A. Yes.

Q. Let me hand you what has been identified as Exhibit 3.

[Exhibit 3]

Can you explain what Exhibit 3 is?

A. It represents my depiction of a Domestic Corporation with a Domestic Subsidiary and a Foreign Subsidiary.

Q. Mr. Jacobsen, what are the assumptions you have made in preparing Exhibit 3?

A. Well, the assumptions we've made are that we've got a Parent Corporation with two 80% or more owned subsidiaries; one is a Domestic Subsidiary and one is a Foreign Subsidiary. Both of the subsidiaries have $200,000 worth of pretax income; they each paid $100,000 to their respective taxing jurisdictions, leaving $100,000 of after-tax income that would be available for a dividend distribution.

Q. Now, you and I have agreed to adopt the parties' definition of the Foreign Subsidiary. How are you defining Domestic Subsidiary for the purposes of your testimony?

A. A Domestic Subsidiary is one that is incorporated in one of the states of the United States.

Q. Let me hand you what has been identified as Exhibit 4.

[Exhibit 4]

Can you explain what Exhibit 4 is?

A. It is my calculation giving an example of the tax effects of a dividend received from a Domestic Subsidiary.

Q. Would you explain how a dividend declared by a Domestic Subsidiary was treated by its Parent Corporation for federal income tax purposes during 1981?

A. All right. This illustration is a dividend from a domestic subsidiary, and again our assumptions are that we start with the domestic subsidiary has $200,000 worth of pretax profit (sic). It paid U.S. tax of $100,000 and it's got after-tax profits of $100,000 available to pay a dividend. In fact, it does declare a dividend of $100,000 to its U.S. parent, and that dividend is picked up on the U.S. Parent's income tax return. The provision in the Internal Revenue Code in this case allows for a 100% exclusion, so there is no taxable income after that exclusion being recorded in the U.S. tax return.

Q. Now, you are referring to what has been identified as Exhibit 4?

A. Correct.

Q. So for federal income tax purposes, the Parent does not include any of the $100,000 dividend declared by its Domestic Subsidiary for federal income tax purposes?

A. That is correct.

Q. Would you please explain now how the dividend declared by the Domestic Subsidiary was treated by its Parent Corporation for Iowa income tax purposes during 1981?

A. All right. For Iowa income tax purposes we—we start with the federal taxable income, which in this case we said there was none because it was totally excluded for federal income tax purposes, so for Iowa purposes we also have none.

Q. This again is the bottom portion of Exhibit 4?

A. That is correct.

Q. So when a Domestic Subsidiary declares a dividend to its U.S. Parent, none of the dividend is includable in Iowa income?

A. That is correct.

Q. Let me hand you what has been identified as Exhibit 5.

[Exhibit 5]

Can you explain what Exhibit 5 is?

A. It is my calculation giving an example of the tax effect of a dividend received from a Foreign Subsidiary.

Q. Fine. Would you please explain now how a dividend declared by a Foreign Subsidiary was treated by its Parent Corporation for federal tax purposes during 1981?

A. This is our Exhibit 5, and again our assumptions are the same as the Domestic Subsidiary. The Foreign Subsidiary had $200,000 worth of pretax income, it paid $100,000 to its foreign jurisdiction or foreign government for income tax purposes, leaving $100,000 worth of after-tax income. The $100,000 actually was a dividend declared in this example and recorded for the U.S. Parent. In this case, the U.S. Parent also has to pick up a foreign tax paid by the Foreign Subsidiary, or referred to

as the gross-up, recording a total of $200,000 of income for tax purposes.

Q. I note there that you include in the Parent's federal taxable income $200,000. Is $100,000 of the dividend declared and $100,000 of an item you call gross-up? Can you explain briefly and as simply as you can what gross-up is?

A. Gross-up is the amount of foreign income tax that has been paid by the Foreign Subsidiary on its income from which the dividend was declared. It is included in the U.S. Parent's federal income, and provides the U.S. Parent with a credit against the Parent's tax for U.S. tax purposes.

Q. Now, gross-up is tax paid by the Foreign Subsidiary to one or more foreign governments?

A. That is correct.

Q. And that is the portion attributable to the dividend actually declared in favor of the Parent?

A. Again, correct.

Q. And it exists because of the tax credit given by the United States government?

A. That is correct. That is the mechanism for avoiding double taxation for U.S. tax purposes.

Q. Now, would you explain how a dividend declared by a Foreign Subsidiary was treated by its Parent Corporation for Iowa income tax purposes during 1981?

A. Again, on the bottom part of our Exhibit 5, we start with the $200,000 that is included in the federal taxable income. The State of Iowa allows the exclusion for the gross-up, or the $100,000, under Rule 54.2(3), leaving $100,000 subject to Iowa apportionment.

CROSS EXAMINATION

Q. Mr. Jacobsen, dividends, whether declared by a Domestic Subsidiary or a Foreign Subsidiary, are declared from the earnings of the subsidiary, isn't that correct, sir?

A. That is correct.

Q. And your testimony about the gross-up, which you indicated was included in federal taxable income, isn't the only reason for that is for purposes of calculation of the foreign tax credit (sic)?

A. That's correct.

Q. And if a corporation elects to deduct foreign taxes on its tax return rather than claim the foreign tax credit, gross-up never comes into play, does it?

Q. That is correct.

REDIRECT EXAMINATION

Q. One more brief question then, Mr. Jacobsen. When the Domestic Parent, the recipient of dividends, does not elect the federal foreign tax credit, then am I correct that this amount would be $100,000 in your example?

A. That is correct.

Q. And that the apportionable income would remain $100,000 for Iowa tax purposes?

A. That is also correct.

Q. So for Iowa tax purposes, it makes absolutely no difference whether the parent elects the federal foreign tax credit as far as what the bottom line is in your example?

A. Or income. That is correct.

23. Attached hereto are photocopies of the following:

Exhibit 6 - S. 1974, introduced in the U.S. Senate on December 18, 1985. This bill was not acted upon by the Congress.

Exhibit 7 - A three-page article from the February 12, 1986, edition of the *Daily Report for Executives*, published by the Bureau of National Affairs, Inc. This article contains a true and correct copy of the text of a letter dated January 30, 1986, from George P. Shultz, United States Secretary of State, to the governors of the States of Idaho, Montana, New Hampshire, Alaska, California and North Dakota.

Exhibit 8 - An eight-page letter dated March 5, 1986, from the Secretary of the Treasury, James A. Baker, III, to United States Senator Robert Packwood.

Exhibit 9 - A letter dated March 14, 1986, to California Assembly Republican Leader Pat Nolan from J. Roger Mentz, Acting Assistant Treasury Secretary (Tax Policy), published in the March 24, 1986, edition of *Tax Notes*.

Exhibit 10 - H.R. 2940, introduced in the U.S. House of Representatives on July 15, 1987.

Exhibit 11 - A press release issued January 21, 1988, by the Unitary Tax Campaign, which is a group of large United Kingdom corporations with operations in the United States and other foreign nations. Attached to the press release is a true and correct copy of "An Early Day Motion" referred to in the press release.

24. Iowa does not use the worldwide unitary combined reporting method to determine Iowa taxable income. The

executive branch of the Federal Government has not sued any State to stop inclusion of dividends declared by Foreign Subsidiaries in the State preapportionment net income base, is not involved in any judicial proceeding designed to preclude such inclusion, and has not otherwise ordered the States to stop such inclusion. The State Department of the Federal Government opposed such inclusion at the time that the Supreme Court considered *Container Corp. v. Franchise Tax Board*, 463 U.S. 159 (1983). The United States has no tax treaties which forbid inclusion of Foreign Subsidiary dividends in the preapportionment net income base of a Domestic Corporation and, at the time that this Stipulation was executed, the Congress has not enacted any legislation that specifically forbids or otherwise limits States from including dividends declared by Foreign Subsidiaries in the preapportionment net income base.

25. Pursuant to §§ 422.28 and 422.41, *Code of Iowa*, Old Kraft timely filed a protest with the hearing officer of the Department with respect to the assessment of additional corporate income tax, interest and fees contained in the Notice of Assessment.

26. In the event any of the issues in this case are decided in favor of Protestor, it and its former affiliate, Dart Industries, Inc. ("Dart"), shall, by reason of written agreements between Protestor and the Department and between Dart and the Department entered into in October 1986, have full use, benefit and advantage of such decision with respect to calendar year 1975 and all years thereafter as to Protestor and with respect to calendar year 1971 and all years thereafter as to Dart.

27. If Iowa Department of Revenue and Finance (Department) personnel were called as witnesses in this cause by the Department, they would testify as follows:

a. The Department has conducted a study of the amount paid of Iowa corporate income tax associated with dividends which are attributable to Foreign Sub-

sidiaries located in foreign countries and doing no business in the United States and which are included in the preapportionment business income base of the parent Domestic Corporation subject to Iowa corporation income tax. The Department's study estimates that historically $6 million per year in Iowa tax was paid and relates to these dividends. For a three-year period, there would be $18 million tax attributable to such dividends. The amount of interest that would be accrued on this $18 million amount, if it were subject to refund, would be approximately $2 million with interest computed through November 30, 1987, and such interest would be approximately $4 million with interest computed through December 31, 1988.

b. The amount of tax associated with the inclusion of these dividends in the preapportionment business income base of the parent Domestic Corporation subject to Iowa corporation income tax and which the Department has assessed to such Domestic Corporations but which has not been paid is approximately $4.2 million. However, a portion of such assessed tax was untimely assessed under the decision of the Iowa Supreme Court in *Kelly-Springfield Tire Co. v. Iowa State Board of Tax Review*, 414 N.W. 2d 113 (Iowa 1987). Therefore, the amount of timely assessed tax is approximately $2 million. The amount of interest is approximately $900,000 computed through November 30, 1987, which has accrued upon this $2 million of tax. The interest would be approximately $1.1 million computed through December 31, 1988. The amounts in this paragraph (b) are not included in paragraph (a).

c. The amount of Iowa tax associated with these dividends which the Department has assessed, which has been paid, and which, like Kraft, Inc., and Dart Industries, Inc., is subject to a specific agreement to refund in the event that the taxpayer successfully

challenged the validity of inclusion of such business income dividends in the Domestic Corporation's preapportionment income base is approximately $900,000. Of this amount, approximately $700,000 relates specifically to Kraft, Inc., and Dart Industries, Inc. However, a portion of such tax was untimely assessed under the decision of the Iowa Supreme Court in *Kelly-Springfield Tire Co. v. Iowa State Board of Tax Review*, 414 N.W. 2d 113 (Iowa 1987). Therefore, the amount of timely assessed tax is approximately $785,000, of which approximately $620,000 is attributable to Kraft, Inc., and Dart Industries, Inc. The amount of interest upon this $785,000, which the Department agrees would be refunded if Kraft, Inc., is successful in its constitutional challenge to the inclusion of these dividends in the preapportionment income base, would be $200,000 computed through November 30, 1987. The amount of interest would be $280,000 computed through December 31, 1988. The agreement between Kraft, Inc., and the Department was entered into on October 24, 1986, a copy of which is attached as Exhibit "A." The agreement between Dart Industries, Inc., and the Department was entered into on October 24, 1986, a copy of which is attached as Exhibit "B". The Department will honor these agreements and also agrees that, by reason of such agreement, any tax associated with Foreign Subsidiary dividends for subsequent years not expressly mentioned in the agreements by taxpayers within this paragraph (c) together with statutory interest will be refunded or payment will not be enforced, provided Kraft, Inc., is successful in its constitutional challenge to inclusion of these dividends in the preapportionment net income base. The amounts of tax associated with these dividends listed in this paragraph (c) are not included in the figures in paragraphs (a) and (b).

d. The total impact of *Kelly-Springfield* case upon Iowa corporate income tax revenues is set forth in Exhibit "C" attached to this stipulation.

28. If Iowa Department of Management personnel were called as witnesses in this cause by the Department, they would testify as follows:

a. As of October 31, 1987, the state budget, based upon Iowa revenues as estimated by the state revenue estimating conference created by Iowa Code § 8.22A and which become part of the unencumbered general fund, for the fiscal year ending June 30, 1988, is estimated to produce revenues of about $2.530 billion. This estimate does not take into account a decrease in Iowa revenues under the decision of the Iowa Supreme Court in *Kelly-Springfield Tire Co. v. Iowa State Board of Tax Review*, 414 N.W. 2d 113 (Iowa 1987). The above estimate of Iowa revenues which will become part of the unencumbered general fund, for the fiscal year ending June 30, 1988, does take into account the recent enactment by the Iowa legislature of House File 689, Acts of 72nd G.A., Special Session. As of October 31, 1987, it is estimated that the unencumbered general fund balance, on June 30, 1988, will be zero.

b. If the State of Iowa would have to refund in the fiscal year ending June 30, 1988, $20 million ($18 million tax and $2 million interest) in paragraph 27(a) and cancel the $2.9 million ($2 million tax and $900,000 interest) in paragraph 27(b), the estimated balance in the general fund, as of June 30, 1988, would be reduced by $22.9 million and to maintain a zero balance in the unencumbered general fund, there would have to be a corresponding reduction of expenditures and/or increase in Iowa revenues.

c. For the fiscal year ending June 30, 1989, it is estimated, as of October 31, 1987, that the $2.530 billion state budget for the prior fiscal year can be increased by 3 percent by reason of anticipated estimated economic growth in Iowa revenues for the fiscal year on the basis of current law which produces Iowa revenues. Even with such estimated growth, it is estimated that the unencumbered general fund balance, as of June 30, 1989, would be $800,000, unless revenues are increased and/or expenditures are reduced.

d. If the State of Iowa would have to refund in the fiscal year ending June 30, 1989, $22 million ($18 million tax and $4 million interest) in paragraph 27(a) and cancel the $3.1 million ($2 million tax and $1.1 million interest) in paragraph 27(b), the estimated balance in the general fund, as of June 30, 1989, would be reduced by $25.1 million. As of June 30, 1989, there would be an estimated deficit of at least $24.3 million, unless revenues are increased and/or expenditures are reduced.

e. In preparations of state budgets, the Department of Management relies upon taxes paid to the State of Iowa and tax assessments made by the Department of Revenue and Finance. The legislature, in approving the state budget, relies upon such taxes (including those Iowa corporate income taxes associated with dividends payable to Domestic Corporations by Foreign Corporations). The possible refunds for taxes associated with these dividends have never been built into state budgets for any fiscal year. By reason of the state of the economy in Iowa in the 1980s, a great reliance is placed on revenues projected for the Iowa state budgets.

29. The Department has projected that the State of Iowa would have collected approximately $894.1 million in the fiscal year ending June 30, 1988, from the Iowa individual income tax imposed for the calendar year 1987 under the provisions of Senate File 523 enacted by the 1987 First

Special Session of the 72nd General Assembly of the State of Iowa, which convened June 4, 1987, and adjourned June 6, 1987. This information was provided by the Department to the members of the General Assembly prior to the passage of Senate File 523.

The Department has projected that the State of Iowa will collect approximately $868.2 million in the fiscal year ending June 30, 1988, from the Iowa individual income tax imposed for the calendar year 1987 under the provisions of House File 689 enacted by the 1987 Second Special Session of the 72nd General Assembly of the State of Iowa, which convened and adjourned October 27, 1987. This information was provided by the Department to the members of the General Assembly prior to the passage of House File 689.

The Department has projected that the State of Iowa would have collected approximately $993 million in the fiscal year ending June 30, 1988, from the Iowa individual income tax for the calendar year 1987 if the General Assembly of the State of Iowa had conformed Iowa law to the provisions of the Internal Revenue Code of 1986 and not otherwise changed any other portion of the Iowa individual income tax law for that in effect for calendar year 1986. This information was provided by the Department to the members of the General Assembly prior to the passage of Senate File 523.

30. If Iowa Department of Revenue and Finance (Department) personnel were called as witnesses in this cause by the Department, they would testify as follows:

After the General Assembly enacted Senate File 523 and prior to enactment of House File 689, the state revenue estimating conference revised its general fund state budget revenue projections by an increase of $16 million for the fiscal year ending June 30, 1988. In addition, if House File 689 is extended by the 1988 session of the General Assembly and couples the Iowa individual income

tax to the Internal Revenue Code of 1986 for the 1988 tax year, an additional $9 million of individual income tax revenue associated with the 1988 tax year and with the fiscal year ending June 30, 1988, will accrue to the State's general fund. The members of the General Assembly requested the Department to use these revenue assumptions in forecasting a model which would approximate the $894.1 million projection associated with Senate File 523. The Department believes that these revenue assumptions explain why the General Assembly enacted House File 689 with a revenue projection of $868.2 million rather than one which would project $894.1 million.

31. If Legislative Services Bureau personnel were called as witnesses in this cause by the Department, they would testify as follows:

The following exhibits are in the custody of the Legislative Services Bureau and were available to members of the General Assembly prior to the October 27, 1987, second special legislative session which enacted House File 689:

a. Exhibit D which is an article in the September 7, 1987, issue of Forbes Magazine.

b. Exhibit E which are comments submitted to the State Tax Reform Study Committee by the Iowa Society of Certified Public Accountants.

c. Exhibit F which are comments submitted to the State Tax Reform Study Committee by the Iowa State Bar Association.

d. Exhibit G which are comments submitted to the State Tax Reform Study Committee by Rockwell International Corporation.

e. Exhibit H which are comments submitted to the State Tax Reform Study Committee by Speaker of the House Donald D. Avenson.

f. Exhibit I which are minutes and attachments thereto of the State Tax Reform Study Committee.

g. Exhibit J which is the final document, including final report and various attachments, of the State Tax Reform Study Committee.

32. The Department has jurisdiction of the parties in this proceeding.

33. The principal issue raised by the Protestor to be determined in this proceeding is whether the Iowa Business Tax on Corporations (Division III of Chapter 422, *Code of Iowa*) is unconstitutional on its face to the extent that it requires a Domestic Corporation to include in its "net income" (as that term is defined in §422.35, *Code of Iowa*) dividends declared by its Foreign Subsidiaries whereas dividends declared by Domestic Subsidiaries are excluded from such net income. Other issues raised by the Protestor are: (i) whether the Iowa Business Tax on Corporations, considered with income taxes imposed by the United States and foreign governments with respect to such dividends declared by Foreign Subsidiaries and the income from which the dividends were declared, results in facially unconstitutional multiple taxation; and (ii) whether the Iowa Business Tax on Corporations, to the extent of its treatment of dividends declared by Foreign Subsidiaries facially results in an unconstitutional contravention of the foreign policy of the United States and thereby denies to the federal government its constitutional role as the single controlling voice in foreign affairs. Specifically, this contested case proceeding involves the following provisions of the Constitution of the United States and/or the Constitution of the State of Iowa:

Article I, Section 8, clause 3 of the Constitution of the United States (the Commerce Clause);

The Due Process Clause of Section 1 of the Fourteenth Amendment to the Constitution of the United States;

The Equal Protection Clause of Section 1 of the Fourteenth Amendment to the Constitution of the United States;

The Supremacy Clause of Article VI, Clause 2 of the Constitution of the United States;

The Due Process Clause of Article I, Section 9 of the Constitution of the State of Iowa;

The uniform operation of laws provisions of Article I, Section 6 and Article III, Section 30 of the Constitution of the State of Iowa.

34. If the Iowa Business Tax on Corporations is found to be facially unconstitutional with respect to one or more of the issues in paragraph 33, the Department raises the further issue to be determined in this proceeding of whether such a decision can be applied to other taxpayers prospectively only, and, if so, the scope of any such prospective ruling.

Respectfully submitted,

s/Harry M. Griger
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APPENDIX E

EXHIBIT 1

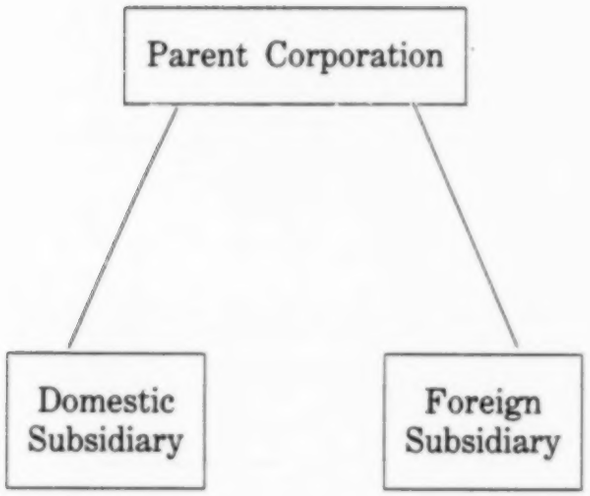
Relevant exhibits to the Stipulation follow. (All other exhibits are omitted.)

Company	Nation of Incorporation
Dominion Dairies Ltd.	Canada
Kraft Limited	Canada
Kraft Foods S/A	Denmark
Kraft G.m.b.H.	Germany
Kraft S.p.A.	Italy
Alimentos Kraft de Venezuela C.A.	Venezuela

EXHIBIT 2

	1981		
Company	Dividends Declared	Foreign Income Taxes Withheld	Dividends Received By Old Kraft
Dominion Dairies Ltd.	$ 1,903,139	$ 285,471	$ 1,617,668
Kraft Limited	4,924,944	738,742	4,186,202
Kraft Foods S/A	298,214	14,911	283,303
Kraft G.m.b.H.	727,287	109,093	618,194
Kraft S.p.A.	819,840	40,992	778,848
Alimentos Kraft de Venezuela C.A.	1,508,391	301,678	1,206,713
Total	$10,181,815	$1,490,887	$8,690,928

EXHIBIT 3



- Both Subsidiaries have income before tax of $200,000.
- Both Subsidiaries pay a tax to their respective taxing jurisdictions of $100,000.
- Both Subsidiaries have earnings after tax and available to be distributed to Parent Corporation of $100,000.

EXHIBIT 4

DIVIDEND DECLARED DOMESTIC SUBSIDIARY

	198 X	Year
	$ 200,000	Pretax Profit of Subsidiary
	(100,000)	U.S. Tax Paid by Subsidiary
	$ 100,000	After Tax Profit of Subsidiary
To U.S. Parent	$ 100,000	Declared Dividend by Subsidiary
U.S. Parent	$ 100,000	Dividend Income of Parent Corporation
	(100,000)	Dividend Deduction of the Parent Corporation for Federal Income Tax Purposes
	None	Dividend included in Parent Corporation's Federal Taxable income
Iowa Return	None	Portion of such Dividend includible in Parent Corporation's Iowa Return

EXHIBIT 5

DIVIDEND DECLARED
FOREIGN SUBSIDIARY

	198 X	Year
In U.S. Dollars	$ 200,000	Pretax Profit of Foreign Subsidiary
	(100,000)	Foreign Income Tax Paid by Foreign Subsidiary to Foreign Government
	$ 100,000	After-tax Profit of Foreign Subsidiary
U.S. Parent	$ 100,000	Dividend Declared by Foreign Subsidiary
	100,000	Foreign Tax Paid by Foreign Subsidiary (Gross-up)
	$ 200,000	Dividend Included in Parent Corporation's Federal Taxable Income
Iowa Return	$ 200,000	Portion of Such Dividend Included in Parent Corporation's Iowa Return
	(100,000)	Gross-up Excluded by Iowa Department of Revenue Rule 54.2(3)
	$ 100,000	Apportionable Income

APPENDIX F

IN THE SUPREME COURT OF IOWA

No. 89-1528

O R D E R

KRAFT, INC.,
Appellant,

vs.

IOWA DEPARTMENT OF REVENUE AND FINANCE,
Appellee.

After consideration by the court, en banc, appellant's Petition for Rehearing in the above-captioned case is hereby overruled and denied.

Dated this 19th day of March, 1991.

THE SUPREME COURT OF IOWA

/s/ Arthur A. McGiverin
Arthur A. McGiverin;
Chief Justice

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L O C A L

APPENDIX G

Sections 422.33 and 422.35 of the Iowa Code, as in effect in 1981, provided as follows:

422.33 Corporate tax imposed:

1. A tax is hereby imposed upon each corporation organized under the laws of this state, and upon every foreign corporation doing business in this state, annually in an amount computed by applying the following rates of taxation to the net income received by the corporation during the income year:

a. On the first twenty-five thousand dollars of taxable income, or any part thereof, the rate of six percent.

b. On taxable income between twenty-five thousand dollars and one hundred thousand dollars or any part thereof, the rate of eight percent.

c. On taxable income between one hundred thousand dollars and two hundred fifty thousand dollars or any part thereof, the rate of ten percent.

d. On taxable income of two hundred fifty thousand dollars or more, the rate of twelve percent.

2. If the trade or business of the corporation is carried on entirely within the state, or if the trade or business consists of the operation of a farm and the property is located entirely within the state, the tax shall be imposed on the entire net income, but if such trade or business is carried on partly within and partly without the state, or if the trade or business consists of the operation of a farm and the property is located partly within and partly without the state, the tax shall be imposed only on the portion of the net income reasonably attributable to the trade or business within the state, said net income attributable to the state to be determined as follows:

a. Nonbusiness interest, dividends, rents and royalties, less related expenses, shall be allocated within and without the state in the following manner:

(1) Nonbusiness interest, dividends, and royalties from patents and copyrights shall be allocable to this state if the taxpayer's commercial domicile is in this state.

(2) Nonbusiness rents and royalties received from real property located in this state are allocable to this state.

(3) Nonbusiness rents and royalties received from tangible personal property are allocable to this state to the extent that the property is utilized in this state; or in their entirety if the taxpayer's commercial domicile is in this state and the taxpayer is not taxable in the state in which the property is utilized. The extent of utilization of tangible personal property in a state is determined by multiplying the rents and royalties by a fraction, the numerator of which is the number of days of physical location of the property in the state during the rental or royalty period in the taxable year and the denominator of which is the number of days of physical location of the property everywhere during all rental or royalty periods in the taxable year. If the physical location of the property during the rental or royalty period is unknown, or unascertainable by the taxpayer tangible personal property is utilized in the state in which the property was located at the time the rental or royalty payor obtained possession.

(4) Nonbusiness capital gains and losses from the sale or other disposition of assets shall be allocated as follows:

Gains and losses from the sale or the disposition of real property located in this state are allocable to this state.

Gains and losses from the sale or other disposition of tangible personal property are allocable to this state if the property had a situs in this state at the time of the sale or disposition or if the taxpayer's commercial domicile is

in this state and the taxpayer is not taxable in the state in which the property had a situs.

Gains and losses from the sale or disposition of intangible personal property are allocable to this state if the taxpayer's commercial domicile is in this state.

b. Net nonbusiness income of the above class having been separately allocated and deducted as above provided, the remaining net business income of the taxpayer shall be allocated and apportioned as follows:

(1) Business interest, dividends, rents, and royalties shall be reasonably apportioned within and without the state under rules adopted by the director.

(2) Capital gains and losses from the sale or other disposition of assets shall be apportioned to the state based upon the business activity ratio applicable to the year the gain or loss is determined if the corporation determines Iowa taxable income by a sales, gross receipts or other business activity ratio. If the corporation has only allocable income, capital gains and losses from the sale or other disposition of assets shall be allocated in accordance with paragraph "*a*", subparagraph (4).

(3) Where income is derived from business other than the manufacture or sale of tangible personal property, the income shall be specifically allocated or equitably apportioned within and without the state under rules of the director.

(4) Where income is derived from the manufacture or sale of tangible personal property, the part attributable to business within the state shall be in that proportion which the gross sales made within the state bear to the total gross sales.

(5) Where income consists of more than one class of income as provided in subparagraphs (1) to (4) of this paragraph, it shall be reasonably apportioned by the busi-

ness activity ratio provided in rules adopted by the director.

(6) The gross sales of the corporation within the state shall be taken to be the gross sales from goods delivered or shipped to a purchaser within the state regardless of the f.o.b. point or other conditions of the sale, excluding deliveries for transportation out of the state.

For the purpose of this section, the word "sale" shall include exchange, and the word "manufacture" shall include the extraction and recovery of natural resources and all processes of fabricating and curing. The words "tangible personal property" shall be taken to mean corporeal personal property, such as machinery, tools, implements, goods, wares, and merchandise, and shall not be taken to mean money deposits in banks, shares of stock, bonds, notes, credits, or evidence of an interest in property and evidences of debt.

3. If any taxpayer believes that the method of allocation and apportionment hereinbefore prescribed, as administered by the director and applied to his business, has operated or will so operate as to subject him to taxation on a greater portion of his net income than is reasonably attributable to business or sources within the state, he shall be entitled to file with the director a statement of his objections and of such alternative method of allocation and apportionment as he believes to be proper under the circumstances with such detail and proof and within such time as the director may reasonably prescribe; and if the director shall conclude that the method of allocation and apportionment theretofore employed is in fact inapplicable and inequitable, the director shall redetermine the taxable income by such other method of allocation and apportionment as seems best calculated to assign to the state for taxation the portion of the income reasonably attributable to business and sources within the state, not exceeding,

however, the amount which would be arrived at by application of the statutory rules for apportionment.

4. In addition to all taxes imposed under this division, there is imposed upon each corporation doing business within the state a state minimum tax for tax preference equal to twenty-five percent of the state's apportioned share of the federal minimum tax. The state's apportioned share of the federal minimum tax is a percent equal to the ratio of the federal minimum tax on preferences attributable to Iowa to the federal minimum tax on all prefences. The director shall prescribe rules for the determination of the amount of the federal minimum tax on preferences attributable to Iowa which shall be based as much as equitably possible on the allocation and apportionment provisions of subsections 2 and 3. For purposes of this subsection, "federal minimum tax" means the federal minimum tax for tax preferences computed under sections 55 to 58 of the Internal Revenue Code of 1954 for the tax year.

422.35 Net income of corporation—how computed. The term "net income" means the taxable income before the net operating loss deduction, as properly computed for federal income tax purposes under the Internal Revenue Code of 1954, with the following adjustments:

1. Subtract interest and dividends from federal securities.

2. Add interest and dividends from foreign securities and from securities of state and other political subdivisions exempt from federal income tax under the Internal Revenue Code of 1954.

3. Where the net income includes capital gains or losses, or gains or losses from property other than capital assets, and such gains or losses have been determined by using a basis established prior to January 1, 1934, an adjustment may be made, under rules and regulations prescribed by

the director, to reflect the difference resulting from the use of a basis of cost or January 1, 1934, fair market value, less depreciation allowed or allowable, whichever is higher. Provided that the basis shall be fair market value as of January 1, 1955, less depreciation allowed or allowable, in the case of property acquired prior to that date if use of a prior basis is declared to be invalid.

4. Subtract fifty percent of the federal income taxes paid or accrued, as the case may be, during the tax year, adjusted by any federal income tax refunds; and add the Iowa income tax deducted in computing said taxable income.

5. Add the amount by which the basis of qualified depreciable property is required to be increased for depreciation purposes under the Internal Revenue Code Amendments Act of 1964 to the extent that such amount equals the net amount of the special deduction allowed on the basis of the amount by which the depreciable basis of such qualified property was required to be reduced for depreciation purposes under the Internal Revenue Code Amendments Act of 1962. The "net amount of the special deduction" shall be computed by taking the sum of the amounts by which the basis of qualified property was required to be decreased for depreciation purposes for the years 1962 and 1963 and subtracting from it the sum of the amounts by which the basis of such property was required to be increased, prior to 1964, for depreciation or disposition purposes under the Internal Revenue Code Amendments Act of 1962.

6. Subtract the amount of the work incentive programs credit allowable for the tax year under section 40 or the jobs tax credit allowable for the tax year under section 44B of the Internal Revenue Code of 1954 to the extent that the credit increased federal taxable income.

7. Subtract the amount of the alcohol fuel credit allowable for the tax year under section 44E of the Internal

Revenue Code of 1954 to the extent that the credit increased federal taxable income.

8. Add the amounts deducted as a result of the treatment provided sale-leaseback agreements under section 168(f)(8) of the Internal Revenue Code of 1954 to the extent that the amounts deduted are not otherwise deductible under the other provisions of the Internal Revenue Code of 1954.

9. Add the amount of windfall profits tax deducted under section 164(a) of the Internal Revenue Code of 1954.

10. If after applying all of the adjustments provided for in this section and the allocation and apportionment provisions of section 422.33, the Iowa taxable income results in a net operating loss, such net operating loss shall be deducted as follows:

a. The Iowa net operating loss shall be carried back three taxable years or to the taxable year in which the corporation first commenced doing business in this state, whichever is later.

b. The Iowa net operating loss remaining after being carried back as required in paragraph "a" of this subsection or if not required to be carried back shall be carried forward fifteen taxable years.

c. If the election under section 172(b)(3)(C) of the Internal Revenue Code of 1954 is made, the Iowa net operating loss shall be carried forward fifteen taxable years.

d. No portion of a net operating loss which was sustained from that portion of the trade or business carried on outside the state of Iowa shall be deducted.

Provided, however, that a corporation affected by the allocation provisions of section 422.33 shall be permitted to deduct only such portion of the deductions for net operating loss and federal income taxes as is fairly and equitably allocable to Iowa, under rules prescribed by the director.

APPENDIX H

Sections 243, 901, 902, 1504, and 7701 of the Internal Revenue Code, as in effect in 1981, provided as follows:

§ 243. Dividends received by corporations

(a) General rule

In the case of a corporation, there shall be allowed as a deduction an amount equal to the following percentages of the amount received as dividends from a domestic corporation which is subject to taxation under this chapter:

(1) 85 percent, in the case of dividends other than dividends described in paragraph (2) or (3);

(2) 100 percent, in the case of dividends received by a small business investment company operating under the Small Business Investment Act of 1958 (15 U.S.C. 661 and following); and

(3) 100 percent, in the case of qualifying dividends (as defined in subsection (b)(1)).

(b) Qualifying dividends

(1) Definition

For purposes of subsection (a)(3), the term "qualifying dividends" means dividends received by a corporation which, at the close of the day the dividends are received, is a member of the same affiliated group of corporations (as defined in paragraph (5)) as the corporation distributing the dividends, if—

(A) such affiliated group has made an election under paragraph (2) which is effective for the taxable years of its members which include such day, and either

(B) such dividends are distributed out of earnings and profits of a taxable year of the distributing corporation ending after December 31, 1963—

(i) on each day of which the distributing corporation and the corporation receiving the dividends were members of such affiliated group, and

(ii) for which an election under section 1562 (relating to election of multiple surtax exemptions) is not effective, or

(C) such dividends are paid by a corporation with respect to which an election under Section 936 is in effect for the taxable year in which such dividends are paid.

* * *

(5) Definition of affiliated group

For purposes of this subsection, the term "affiliated group" has the meaning assigned to it by section 1504(a), except that for such purposes sections 1504(b)(2), 1504(b)(4), and 1504(c) shall not apply.

* * *

§ 901. Taxes of foreign countries and of possessions of United States

(a) Allowance of credit

If the taxpayer chooses to have the benefits of this subpart, the tax imposed by this chapter shall, subject to the limitation of section 904, be credited with the amounts provided in the applicable paragraph of subsection (b) plus, in the case of a corporation, the taxes deemed to have been paid under sections 902 and 960. Such choice for any taxable year may be made or changed at any time before the expiration of the period prescribed for making a claim for credit or refund of the tax imposed by this chapter for such taxable year. The credit shall not be allowed against the tax imposed by section 56 (relating to minimum tax for tax preferences), against the tax imposed for the taxable year under section 72(m)(5)(B) (relating to 10 per-

cent tax on premature distributions to owner-employees), against the tax imposed by section 402(e) (relating to tax on lump sum distributions), against the tax imposed for the taxable year by section 408(f) (relating to additional tax on income from certain retirement accounts), against the tax imposed by section 531 (relating to the tax on accumulated earnings), against the additional tax imposed for the taxable year under section 1351 (relating to recoveries of foreign expropriation losses), or against the personal holding company tax imposed by section 541.

(b) Amount allowed

Subject to the limitation of section 904, the following amounts shall be allowed as the credit under subsection (a):

(1) Citizens and domestic corporations

In the case of a citizen of the United States and of a domestic corporation, the amount of any income, war profits, and excess profits taxes paid or accrued during the taxable year to any foreign country or to any possession of the United States; and

* * *

§ 902. Credit for corporate stockholder in foreign corporation

(a) Treatment of taxes paid by foreign corporation

For purposes of this subpart, a domestic corporation which owns at least 10 percent of the voting stock of a foreign corporation from which it receives dividends in any taxable year shall be deemed to have paid the same proportion of any income, war profits, or excess profits taxes paid or deemed to be paid by such foreign corporation to any foreign country or to any possession of the United States, on or with respect to the accumulated profits of such foreign corporation from which such dividends were paid, which the amount of such dividends (determined without regard to section 78) bears to the amount of such accumulated profits in excess of such income, war profits, and excess profits taxes (other than those deemed paid).

* * *

§ 1504. Definitions

(a) Definition of "affiliated group"

As used in this chapter, the term "affiliated group" means one or more chains of includible corporations connected through stock ownership with a common parent corporation which is an includible corporation if—

(1) Stock possessing at least 80 percent of the voting power of all classes of stock and at least 80 percent of each class of the nonvoting stock of each of the includible corporations (except the common parent corporation) is owned directly by one or more of the other includible corporations; and

(2) The common parent corporation owns directly stock possessing at least 80 percent of the voting power of all classes of stock and at least 80 percent of each class of the nonvoting stock of at least one of the other includible corporations.

As used in this subsection, the term "stock" does not include nonvoting stock which is limited and preferred as to dividends, employer securities (within the meaning for section 409A(l)) while such securities are held under a tax credit employee stock ownership plan, or qualifying employer securities (within the meaning of section 4975(e)(8)) while such securities are held under a (sic) employee stock ownership plan which meets the requirements of section 4975(e)(7).

(b) Definition of "includible corporation"

As used in this chapter, the term "includible corporation" means any corporation except—

(1) Corporations exempt from taxation under section 501.

(2) Insurance companies subject to taxation under section 802 or 821.

(3) Foreign corporations.

(4) Corporations with respect to which an election under section 936 (relating to possession tax credit) is in effect for the taxable year.

[(5) Repealed. Pub. L. 94-455, title X, § 1053(d)(2), Oct. 4, 1976, 90 Stat. 1649.]

(6) Regulated investment companies and real estate investment trusts subject to tax under subchapter M of chapter 1.

(7) A DISC or former DISC (as defined in section 992(a)).

(c) Includible insurance companies

Notwithstanding the provisions of paragraph (2) of subsection (b)—

* * *

(d) Subsidiary formed to comply with foreign law

In the case of a domestic corporation owning or controlling, directly or indirectly, 100 percent of the capital stock (exclusive of directors' qualifying shares) of a corporation organized under the laws of a contiguous foreign country and maintained solely for the purpose of complying with the laws of such country as to title and operation of property, such foreign corporation may, at the option of the domestic corporation, be treated for the purpose of this subtitle as a domestic corporation.

* * *

§ 7701. Definitions

(a) When used in this title, where not otherwise distinctly expressed or manifestly incompatible with the intent thereof—

* * *

(4) Domestic

The term "domestic" when applied to a corporation or partnership means created or organized in the United States or under the law of the United States or of any State.

* * *

APPENDIX I

Section 1.1502-14(a)(1) of the Federal Income Tax Regulations, as in effect in 1981, provided as follows:

§ 1.1502-14. Stock, bonds, and other obligations of members.—(a) *Intercompany distributions with respect to stock*—(1) *Dividends.* A dividend distributed by one member to another member during a consolidated return year shall be eliminated. For purposes of this paragraph, the term "dividend" means a distribution which is described in section 301(c)(1) other than a distribution described in section 243(c)(1).

APPENDIX J

State Taxing Schemes

States That Do Not Start With Federal Taxable Income

Ala. Code §§ 40-18-34, -18-35(a)(14) (1985 & Supp 1990).

Ark. Code Ann. §§ 21-51-404(a)(1), (b)(9), -51-709 to -717 (1987 & Supp. 1989).

Cal. Rev. & Tax. Code §§ 24271, 24341, 25510 (West 1979 & Supp. 1991).

D.C. Code Ann. §§ 47-1803.1, -1803.2, -1810.1 to -1810.3 (1990).

Miss. Code Ann. §§ 27-7-13, -7-15 (1990).

Utah Code Ann. §§ 59-7-106, -7-106(2)(d), -7-108 (1987).

States Identical to Iowa

N.M. Stat. Ann. §§ 7-2A-2, 7-2A-2(C) (1988).

Vt. Stat. Ann. tit. 32, §§ 5811, 5811(18) (1981 & Supp. 1990).

States Similar to Iowa

Colo. Rev. Stat. §§ 39-22-304(1), -22-303(10)(b) (Supp. 1990).

Kan. Stat. Ann. §§ 79-32,138, -32,138(a), -32,138(c)(vi) (1989).

Me. Rev. Stat. Ann. tit. 36, §§ 5200-A, 5200-A(2)(G) (1990).

Mo. Ann. Stat. §§ 143.431, 143.431(1), (2) (Vernon 1976).

Okla. Stat. Ann. tit. 68, §§ 2353, 2353(10), 2358(A)(4)(b) (West Supp. 1991).

R.I. Gen. Laws §§ 44-11-11, -11-11(a), -11-12(1)(b) (1988 & Supp. 1990).

S.C. Code Ann. §§ 12-7-415, -7-1110, -7-1120(2) (Law. Co-op 1976 & Supp. 1990).

States With Noncomparable Variations

Alaska Stat. §§ 43.19.010 (art. III), 43.20.021, 43.20.065 (1990).

Idaho Code §§ 63-3022, -3022(e), (f), -3027B, -3027C(c)(1)(3) (1989 & Supp. 1990).

Mont. Code Ann. § 15-31-113 (1989 & Supp. 1990); *Baker Bancorporation Inc.* v. *Department of Revenue*, 202 Mont. 94, 657 P.2d 89 (1982).

N.H. Rev. Stat. Ann. §§ 77-A:1(III)(a), -A:3(II)(b), -A:4(IV) (Supp. 1990).

States That Exclude All Dividends

Ariz. Rev. Stat. Ann. §§ 43-1101(1), -1121(2), -1122(7) -1122(5) (Supp. 1990).

Conn. Gen. Stat. Ann. §§ 12-213, -217(a)(D) (West Supp. 1991).

Del. Code Ann. tit. 30, §§ 1903, 1903(a), 1903(a)(2) (1985 & Supp. 1990).

Fla. Stat. Ann. §§ 220.12, 220.13, 220.13(1), 220.13(1)(b)(2)(a), 220.13(d)(2) (West Supp. 1991).

Ga. Code Ann. §§ 48-7-21, -7-21(a), -7-21(b)(8)(A) (1982 & Supp. 1990).

Ill. Stat. Ann. ch. 120, ¶ 2, §§ 203, 203(b)(2)(O), 203(e)(1) (Smith-Hurd Supp. 1991).

Ind. Code Ann. §§ 6-3-1-3.5, -1-3.5(b), -2-12(b) to (e) (West 1989 & Supp. 1990).

Ky. Rev. Stat. Ann. §§ 141.010(12)(b), 141.010(13), 141.010(13)(b) (Michie 1991).

Md. Tax-Gen. Code Ann. §§ 10-304, -304(1), -307(d), -307(d)(1) (1988).

Mich. Stat. Ann. §§ 7.558(3)(3), 7.558(9)(7)(a) (Callaghan 1984 & Supp. 1990).

Neb. Rev. Stat. §§ 77-2734.04, -2734.04(6), -2716(5) (1990).

Ohio Rev. Code. Ann. §§ 5733.04(I), 5733.04(I)(2), (4) (Anderson Supp. 1990).

Pa. Stat. Ann. tit. 72, §§ 7401(3)(1)(a), (b) (Purdon 1990).

Va. Code Ann. §§ 58.1-402, -402(A), -402(C)(8), (10) (Supp. 1990).

W. Va. Code §§ 11-24-3a(24), -24-6, -24-6(c)(10)(A) (1987 & Supp. 1990).

States That Tax All Dividends Equally

Haw. Rev. Stat. §§ 235-2.3(a), 235-7(c), 235-7(c)(1)(3) (Supp. 1989).

La. Rev. Stat. Ann. §§ 243(A)(4), 287.65, 287.73(B)(3), 287.73(C)(1) (West 1990).

Mass. Gen. Laws Ann. ch. 60, §§ 30(5)(b), 30(5)(b)(i), 38(a)(1) (West 1988).

Minn. Stat. Ann. §§ 290.01 subd. 19, 290.01 subd. 19c(6), 290.21 subd. 4(a) to (b) (West 1989 & Supp. 1991).

N.J. Stat. Ann. §§ 54:10A-4(k), -4(k)(2)(B), -4(k)(5) (West Supp. 1991).

N.Y. Tax Law §§ 208.9, 208(9)(a)(1), (2), 208(9)(b)(2) (McKinney 1986 & Supp. 1991).

N.C. Gen. Stat. §§ 105-130.4(a)(1), -130.4(i), -130.5, -130.5(a)(7), -130.5(b)(3), -130.7(4) (1989 & Supp. 1990).

N.D. Cent. Code §§ 57-38-01(8), -38-01.3(1)(g), (i) (Supp. 1989).

Or. Rev. Stat. §§ 317.010(10), 317.267(1) to (2) (1989).

Tenn. Code Ann. §§ 67-4-805(a)(1), -4-805(b)(2)(A) (1989).

Wis. Stat. Ann. §§ 71.26(3), 71.26(3)(j) (West 1989 & Supp. 1990).

APPENDIX K

RULE 29.1 STATEMENT

The subsidiaries of petitioner other than wholly-owned subsidiaries are as follows:

464088 Ontario Ltd.

Abal Hermanos S.A.

Ajinomoto GF, Inc.

Artes Graficas Unidas S.A.

Australian Dried Fruit Agency

Bell Pack, Inc.

C.A. Tabacalera Nacional

Cafe Grand Mere

Cerveceria Nacional Dominicana C. Por A.

Ceylon Tobacco Company Limited

CIA Inversiones Puerto Plata S.A.

Cigarros La Tabacalera Mexicana S.A. de C.V.

Comptoir de La Confiserie SNC

Confederation of European Community Cigarette Manufacturer's Ltd.

Crippa e Berger Fonti Levissima

Dairy Industries (Jamaica) Ltd.

Dairy Industries Ltd.

Dong Mei Food Company Ltd.

Dong Suk Foods Corporation

Dong Suk Ginseng

Don Suk Oil & Fats Co. Inc.

E. Leon Jimenes C. Por A.

E.D. & F. Man (Bermuda) Ltd.

Fabrica de Cigarillos El Progreso S.A.

Fattorie Osella S.P.A.

Galas de Mexico S.A. de C.V.

German Merino y CIA Ltda

Godfrey Phillips India, Limited

Grundstuck Sgemeinschaft Jacobs Suchard

Guangtong Food Company Ltd.

HAG GF AG

Hamni Bank

Hostess Frito-Lay

Industria Licorera Hispanoamericana S.A.

Industrias Del Tabaco Alimentos y Bebidas S.A.

International de Vinos, S.A.

International Pet Foods Ltd.

International Tobacco Company Limited

ION S.A.

Jacobs Suchard AG

Jacobs Suchard Budapest GMBH

Jacobs Suchard Pavledes S.A.

Korea First Advertising Co. Ltd.

Kothari Corp. Ltd.

Kotsiopouli Bros.

L.W. de Mexico S.A.-de C.V.

LACTA

Lacteas Andaluzas S.A.
Lacteas La Ribera S.A.
Lakeland Daries Pty. Ltd.
Massalin Particulares S.A.
Maxpax S.A.
Mendiola y Compania, S.A.
Negroni Holding 93
Oper. International Nicoya
Oscar Mayer Cp Co. Ltd.
Philip Morris Espana S.A.
Pietro Negroni France S.A.
Pietro Negroni S.R.L.
Pietro Negroni U.K.
Premier Foods Corp.
Prima Meat Packers, Ltd.
Prmier Tobacco Industries Limited
Prolacteras S.A.
Proveedora Ecuatoriana S.A.
Pusan Insurance
Riespri Alicante S.A.
Riespri Madrid
Riespri Valencia S.A.
Riespri Zaragoza S.A.
Rothman, Benson & Hedges Inc.
Rothman's (UK) Limited
Sam Kwang Glass Co.

Sicma
Sociedad Agricola Comercial Ecuatoriana
Societa di Decaffeinizzazione
Societe Immobilere du 283 Rue de Rosny
Tabacalera Andina S.A.
Tabacalera Centroamericana S.A.
Tabacalera Costarricense, S.A.
Tabacalera de El Salvador S.A. de C.V.
Tabacalera Nacional, S.A.
Tabaco Rubio Ecuatoriano C.A.
Tabacos Norte S.A.
Tabamark S.A.
Taloca y CIA Ltda
Tian Mei Food Company Ltd.